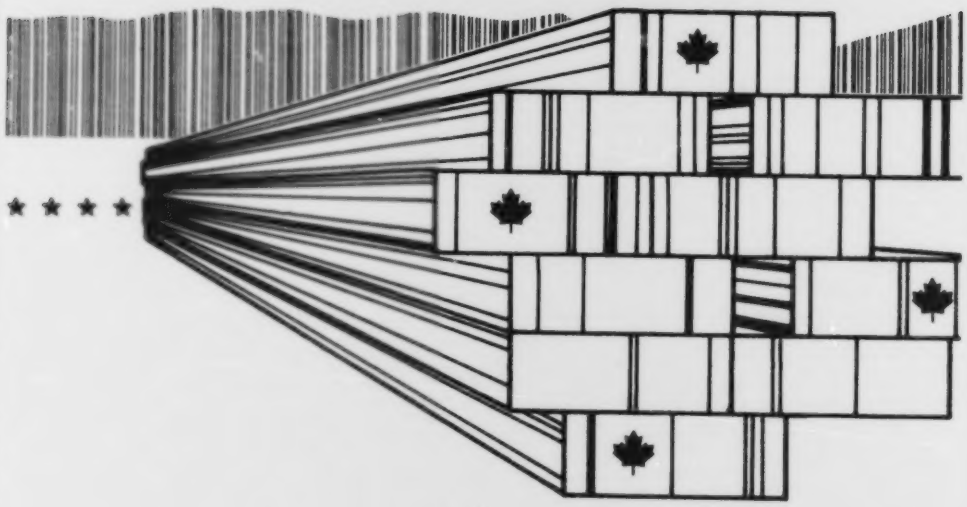
The Softwood Lumber Dispute & Canada~U.S. Trade in Natural Resources



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by
Michael B. Percy
and
Christian Yoder

The Institute for Research on Public Policy /
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Foreword

When the 1986 "phase" of the dispute with the United States over softwood lumber culminated in an agreement based upon Canada's imposition of a 15 per cent export tax, many Canadians were left wondering what had happened to produce a result so radically different from the outcome three years earlier. Canada's share of the U.S. market definitely had increased. Yet provincial policies for the pricing of Crown timber remained the same – notably in British Columbia, the main source of our exports – and, similarly, U.S. trade-remedy laws were nominally unchanged. Why then, did the U.S. Coalition for Fair Lumber Imports succeed in gaining tariff protection for its domestic industry where it had failed previously? Moreover, beyond the specific case of softwood lumber, what are the implications for Canada's other natural resource exports and for the bilateral negotiations under way on a comprehensive free trade agreement?

In this book, commissioned as part of this Institute's Western Resources Program, authors Michael B. Percy and Christian Yoder examine the complex economic and legal arguments that underpinned the petition for a countervailing duty on softwood lumber. Taking the U.S. complaint at face value, they address the question of whether Canada's improved export performance was due to market forces or, as alleged, to timber-pricing policies (on the part of British Columbia in particular) that amounted to unfair subsidization which, in turn, caused injury to U.S. competitors. The evidence marshalled here suggests that, while perhaps the Crown did not capture all of the economic rent from the forest resource, the forgone values were not of

the magnitude claimed by the United States, nor did they provide the basis for greater export volumes and corresponding injury to the U.S. industry.

The subsidy issue is contentious and has been the subject of other research at the IRPP. Further discussion appears in a chapter entitled "The British Columbia Forest Sector: Pros and Cons of the Stumpage System," written by Richard Schwindt in *Resource Rents and Public Policy in Western Canada*, edited by Thomas Gunton and John Richards. Schwindt's research supports the view that the B.C. system fails to collect all the available rents but that the residual would not necessarily give Canadian lumber producers a competitive edge in U.S. markets. Schwindt finds it probable that some portion is captured by the public indirectly (through the imposition of costly social responsibilities on the forest industry) and that unionized labour, too, gets some share; such rents are simply redistributed, with the pattern of redistribution reflecting judgements on matters of equity and, therefore, reflecting ultimately sovereign political choices. Still other uncollected rents may be dissipated by forest companies through practices that do not realize the full market value of the timber resource. As Percy and Yoder stress in the present study, the link between Crown stumpage policies and the volume of lumber exports is far from clear. Cross-border differences in the price of standing timber do not demonstrate the existence of a "subsidy" and, indeed, obscure the real underlying economic relationships.

This study reveals that the success, in effect, of the U.S. countervail action did not follow from the genuine merits of the U.S. industry's case. In fact, Percy and Yoder find that the legal and economic concepts embodied in U.S. trade-remedy law were stretched to such an extent that the legitimacy of the supposedly quasi-judicial process must be questioned. While the letter of the law remained the same, interpretations of it were different, apparently to reflect the Administration's desire to appear more attuned to the prevailing mood of protectionism in the U.S. Congress. Quite simply, the context – the political economy – of the Softwood Lumber dispute changed between 1983 and 1986 and this change tainted – or at least coloured – the process.

One cause of the transformation, the authors contend, is the fact that the United States is becoming increasingly a high-cost producer of resource products. Protectionist trade policy is thus directed more and more at offsetting the comparative advantage of foreign producers arising from the quantity and quality of resource endowments or from greater productivity. This seems to be the sinister meaning of the concept of the "level playing field."

The IRPP is pleased to publish this study at this particular time: not only are discussions with the U.S. under way as part of the process

of replacing the federal export tax with measures at the provincial level, but also, beyond the realm of softwood lumber, negotiations are taking place to secure freer trade across our border for the broadest possible range of goods and services. What lessons do we draw from the Percy-Yoder case study? For Canadian resource producers the implication of this study is that unimpeded access to U.S. markets may not be assured in the long term even if performance is market-based and free of significant subsidy. Legal and economic definitions employed by quasi-judicial trade bodies have become flexible enough, it seems, to accommodate any petition for trade remedy filed by U.S. industry groups under existing law. Moreover, there is the continuing threat that U.S. trade law will be rewritten by a protectionist-minded Congress so as to leave even less room for "unfavourable" interpretation. House and Senate bills now awaiting reconciliation in the Congressional Conference process reflect but the most recent attempts.

As for the free trade negotiations, this case study serves as a telling example of what can happen when individual complaints are subjected to the U.S. process as it stands. Thus, it strongly reinforces the position Canada has taken that an effective mechanism for resolving disputes is needed to insulate Canadian exporters from the unilateral application of U.S. contingent protection. Unless progress along these lines is achieved in a bilateral agreement, the potential gains to Canada from access to U.S. markets, particularly for resource products, either likely would not be realized or could be lost in periodic legal actions before U.S. trade bodies.

Further, the Percy-Yoder analysis demonstrates that a trade deal must expressly include provision for handling the question of subsidies. If a universal definition of domestic or trade-related subsidies is contemplated for all goods and services, its particular relevance to the natural resource industries should be understood and widely accepted, especially by the provincial governments that exercise exclusive jurisdiction over resource development. In order to safeguard Canadian sovereignty, such a definition needs to accommodate continued Crown ownership of natural resources and, more generally, a different role for government in Canada than might be consistent with U.S. politics—or, more correctly, U.S. political rhetoric. Although the study concludes, following the predilections of economists, that the focus of dispute resolution should be on the capability of domestically administered pricing mechanisms to capture fully the economic rents from the resource base, Canadians presumably would want to retain the power to redistribute resource rents according to their own preferences. (This could well mean that even though the Crown declines to collect all of the available rent, it still is not guilty of subsidizing resource production or exports.)

Certainly the use of U.S. benchmarks to value Canadian natural resources must be avoided, not only because of the extra-territoriality their application would imply but also because of the abuse this approach would offer to the notion of comparative advantage, which is the very foundation of the benefits to be derived from international trade. In short, the findings of this study suggest that, in the important area of resolution of trade disputes, Canada should reject mechanisms that are responsive to tides of U.S. protectionism and seek mechanisms that allow for the expression of our own sovereign goals in the management of natural resources, whether destined for export or not.

In publishing this study, the IRPP hopes to enrich the debate that will focus on the trade negotiations over the coming months. In turn, we would like to acknowledge the financial support and analytical contributions received from the British Columbia Ministry of Economic Development and the Canadian Forestry Service – although the views expressed remain those of the authors alone.

Rod Dobell
President

November, 1987

Avant-propos

Quand l'épisode 1986 du différend avec les États-Unis au sujet du bois d'oeuvre s'est soldé par l'établissement d'un droit de 15% sur les exportations canadiennes, nombreux sont ceux qui se sont demandé quelle pouvait bien être la cause d'un changement si radical, en comparaison de ce qui s'était produit trois ans plus tôt. Certes, la part du Canada s'était sensiblement accrue. Pourtant, les politiques provinciales relatives à la fixation des prix du bois des terres de la Couronne étaient restées les mêmes – notamment en Colombie-Britannique, le principal exportateur – et les lois américaines de réajustement étaient, de leur côté, demeurées inchangées. Pourquoi, dans ces conditions, la Coalition américaine pour une réglementation équitable de l'importation du bois d'oeuvre a-t-elle soudainement réussi à avoir gain de cause, alors que jusque là ses efforts n'avaient pu aboutir?

Dans ce livre, commissionné dans le cadre du programme de l'Institut sur les ressources de l'Ouest, les deux auteurs, Michael B. Percy and Christian Yoder, étudient les raisons à l'origine de ce tarif compensatoire pour le bois d'oeuvre. Ils s'efforcent, à partir de la plainte américaine, d'établir si l'accroissement des exportations canadiennes était bien dû à une politique trop libérale de fixation des prix (de la part de la Colombie-Britannique notamment) équivalent à un système inéquitable de subventions déguisées, au préjudice de la concurrence américaine. Tout en reconnaissant qu'il y a bien eu sous-estimation de la valeur du bois de la Couronne, ils pensent cependant que la différence n'est pas telle qu'elle puisse justifier l'importance des

réclamations des États-Unis, ni être la véritable cause de l'accroissement des exportations et du tort en résultant pour l'industrie américaine.

La question du subventionnement déguisé est une source de désaccord et elle a fait l'objet d'autres recherches à l'Institut. La discussion de ce problème apparaît également dans un chapitre intitulé "Le secteur forestier de la Colombie-Britannique : le pour et le contre du droit de coupe", tiré du livre de Richard Schwindt : *Revenus des ressources naturelles et politique générale dans l'Ouest du Canada* (Thomas Gunton et John Richards). Les travaux de Schwindt viennent confirmer que le système de Colombie-Britannique ne permet pas de récupérer tous les revenus possibles. La différence, cependant, ne serait pas telle qu'elle puisse donner aux producteurs de bois d'oeuvre canadiens un net avantage sur les marchés concurrentiels américains. Cet auteur pense qu'une partie de la différence profite indirectement au public (par l'intermédiaire des coûteuses responsabilités sociales imposées à l'industrie forestière), ainsi qu'aux travailleurs syndiqués; la partie des revenus non prélevée directement est simplement redistribuée d'une autre manière, pour se conformer à certains principes d'équité et finalement à des choix politiques pris en tout souveraineté. Pourtant, un certain pourcentage des revenus non prélevés peut être gaspillé par les compagnies, du fait de méthodes qui ne tiennent pas complètement compte de la vraie valeur marchande des ressources forestières. Comme le soulignent Percy et Yoder dans la présente étude, la relation est loin d'être établie entre les mesures réglementant le droit de coupe du bois de la Couronne et le volume de bois exporté. Les différences entre les prix du bois sur pied de part et d'autre de la frontière ne permettent pas de prouver l'existence d'une "subvention" et, en fait, viennent brouiller les véritables relations économiques sous-jacentes.

Cette étude montre que le succès remporté par la politique compensatoire américaine ne provient pas du bien-fondé des réclamations américaines. En fait, Percy et Yoder pensent que les principes légaux et économiques qui servent à justifier cette loi commerciale compensatoire ont été interprétés d'une manière tellement large que la légitimité de toute cette procédure soi-disant parajudiciaire doit être remise en question. Alors que la lettre de la loi demeurait la même, les interprétations qu'on en a faites ont varié, sans doute du fait du désir de l'Administration de donner l'impression d'être plus attentive au courant protectionniste qui prévaut actuellement au Congrès américain. Tout simplement, le contexte de politique économique du différend au sujet du bois d'oeuvre a évolué entre 1983 et 1986, et ce changement a obscurci, ou tout au moins coloré, toute la procédure.

Une des causes de ce changement, selon les auteurs, vient du fait que les États-Unis deviennent, d'une manière croissante, des producteurs de ressources naturelles à prix de revient élevé. La politique commerciale protectionniste vise donc de plus en plus à neutraliser l'avantage relatif des producteurs étrangers qui ont des ressources plus abondantes ou de meilleure qualité, ou dont la productivité est plus élevée. Cela semble être la sombre signification du concept de "terrain de jeu nivelé".

L'Institut est heureux de publier cette étude, à ce moment précis où non seulement nous poursuivons des discussions avec les États-Unis sur les mécanismes de remplacement de la taxe fédérale d'exportation par des mesures au niveau provincial, mais aussi parce que des négociations sont en cours, qui débordent largement la question du bois d'oeuvre, en vue d'établir des relations commerciales plus libres entre nos deux pays, et portant sur le plus grand nombre possible de biens et services. Quelles leçons pouvons-nous tirer de cette étude de Percy et Yoder? Plur les producteurs canadiens de ressources naturelles, il apparaît que le libre accès aux marchés américains ne peut être garanti à long terme, même si la transaction obéit aux lois du marché et est exempte de subvention. Les définitions légales et économiques utilisées par les organismes commerciaux parajudiciaires sont devenues tellement flexibles qu'elles semblent pouvoir justifier toutes les demandes de protection commerciales déposées par les groupes industriels américains, au nom des lois en vigueur. En outre, la loi commerciale américaine risque toujours d'être remaniée par un Congrès à l'esprit protectionniste, dans le but de donner encore moins de prise à une interprétation "défavorable". Les projets de loi du Sénat et de la Chambre, en instance d'arbitrage dans la procédure du Congrès, n'en sont que les plus récents exemples.

Quant aux négociations sur le libre-échange, cette étude montre ce qui peut arriver quand des plaintes particulières sont prises en charge par la procédure américaine, tel qu'elle existe à l'heure actuelle. Elle vient ainsi renforcer le point de vue défendu par le Canada qu'un mécanisme adéquat de résolution des différends doit être instauré, si l'on veut protéger les exportateurs canadiens de l'application unilatérale des mesures de contingentement américaines. A moins qu'on ne parvienne à des progrès en ce sens, les gains potentiels que le Canada pourrait retirer de l'accès aux marchés américains, soit demeureraient illusoires, soit pourraient être perdus par suite d'actions légales prises périodiquement devant les instances commerciales des États-Unis.

L'analyse de Percy et Yoder démontre, qui plus est, qu'un accord commercial doit expressément inclure une clause sur la question des subventions. Si une définition générale de la subvention domestique ou en rapport avec le commerce est envisagée pour tous les biens et

services, sa pertinence particulière, dans le cas des industries de ressources naturelles, devrait être comprise et largement acceptée, spécialement par les gouvernements provinciaux qui exercent une juridiction exclusive sur le développement des ressources. Afin de sauvegarder la souveraineté canadienne, une telle définition devrait tenir compte de la nature spéciale de la propriété des ressources de la Couronne, ainsi que du rôle différent du gouvernement du Canada, d'une manière compatible avec la politique des États-Unis, ou plutôt avec sa rhétorique politique. Bien que, selon l'habitude des économistes, l'étude suggère, en conclusion, que la résolution du différend tient essentiellement dans l'importance de mettre sur pied des mécanismes domestiques de fixation des prix assurant la pleine perception à la source des revenus des ressources naturelles, les Canadiens voudront probablement se réserver le droit de signifier que même si la Couronne décidait de ne pas percevoir tous les revenus des ressources naturelles, les Canadiens voudront probablement se réserver le droit de redistribuer les revenus des ressources comme bon leur semble. (Cela pourrait signifier que même si la Couronne décidait de ne pas percevoir tous les revenus auxquels elle a droit, elle ne serait cependant pas coupable de subventionner l'exploitation des ressources ou les exportations.) L'évaluation de nos ressources naturelles par les juridictions américaines est certainement à éviter, non seulement à cause du fait que ce sont des instances extraterritoriales, mais aussi parce que ce système fausserait la notion d'avantage relatif, qui est fondamentale pour les profits qu'on est en droit d'attendre du commerce international. En bref, les conclusions de cette étude suggèrent que, dans le domaine important de la résolution des différends commerciaux, le Canada devrait proscrire les mécanismes susceptibles d'être influencés par les courants protectionnistes américains et rechercher les moyens qui lui permettent de réaliser ses propres objectifs, en toute indépendance, dans la gestion des ressources naturelles, que celles-ci soit ou non destinées à l'exportation.

Avec la publication de cette étude, l'Institut de recherches politiques espère pouvoir enrichir le débat qui va se concentrer sur les négociations commerciales dans les mois à venir. Nous voudrions également remercier ici le ministère du Développement économique de la Colombie-Britannique et le Service forestier canadien pour leur aide financière et la documentation qu'ils ont bien voulu mettre à notre disposition. Toutefois, les opinions exprimées demeurent exclusivement celles des auteurs de cette étude.

Rod Dobell
Président
Novembre 1987

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Executive Summary

The Issue

In May 1983 the issue of countervailing duties on Canadian softwood lumber exports to the United States appeared to have been resolved once and for all. The United States Department of Commerce had found that Canada's policies regarding the pricing and allocation of the timber harvest did not constitute a countervailable subsidy to the softwood lumber industry. Softwood timber from Crown lands was found to be freely available on similar terms regardless of the industry or recipient and was not provided at preferential rates to softwood lumber producers. Canadian timber pricing and allocation policies thus successfully met the tests of "general availability" and preferentiality employed by the Department of Commerce in investigations of alleged subsidy practices. Meeting either test required the Department of Commerce to reject the imposition of countervailing duties on Canadian softwood lumber.

In May 1986 the U.S. Coalition for Fair Lumber Imports filed a petition before the International Trade Commission again alleging that Canadian timber pricing and allocation policies constituted a countervailable subsidy and requesting that a 27 per cent duty be imposed on Canadian softwood lumber imports. The evidence provided by the coalition differed little in substance from that offered in the 1982-1983 phase of the dispute. Nor had either the law or the facts of the case changed in the interim. The only significant change was that the share of U.S. domestic consumption of softwood lumber

accounted for by Canadian imports had risen from 28.5 per cent in 1983 to 31.6 per cent in 1985.

In October 1986 the Department of Commerce reversed its earlier decision and in a preliminary determination found that Canadian timber pricing and allocation policies did constitute a countervailable subsidy. Moreover, the operational criteria employed by the Department of Commerce in evaluating the general availability and degree of preferentiality of alleged subsidy programs had become much more open-ended and flexible, and so loosely grounded in economic theory that for countries exporting raw or processed material to the United States, virtually any government policy for managing natural resources could be construed as countervailable.

Expecting that the final determination would uphold the preliminary finding and perhaps impose a countervailing duty even higher than that recommended in the preliminary determination, the Canadian government agreed in late December 1986 to impose a 15 per cent *ad valorem* export tax on softwood lumber destined for the United States. In response, countervail proceedings in the United States were terminated.

The Memorandum of Understanding between Canada and the United States resolving the Softwood Lumber dispute (and subsequently enacted as legislation by the Canadian Parliament) is historic with enormous implications for the Canadian forest products industry in particular and Canadian resource industries in general.

Basic Objectives of the Study

This study was motivated by three basic objectives. The first was to examine whether the 1986 phase of the Softwood Lumber dispute was an example of an isolated, albeit important, trade dispute between Canada and the United States arising from short-term political and economic pressures and characteristics specific to the softwood lumber industry. Or was it evidence of a longer term problem derived from structural factors, and thus likely to affect a variety of Canadian industries relying on the U.S. market? The study's second objective was to assess the available evidence regarding two sets of factors – relative cost levels and resource endowments, and explicit and implicit subsidies to Canadian softwood lumber producers – in explaining the current pattern of trade in softwood lumber between Canada and the United States. The final objective was to examine how the events of this case were evaluated in the allegedly impartial quasi-judicial U.S. trade bodies such as the International Trade Administration and the International Trade Commission.

Summary of Conclusions

This study of the 1986 phase of the Softwood Lumber dispute leads the authors to be very pessimistic regarding the long-term future of Canada-U.S. trade relationships, especially in the area of unprocessed and processed resource products. In part the Softwood Lumber dispute was a reflection of the confluence of a number of short-term factors whose joint occurrence is unlikely to be repeated, at least not to the same degree. The large appreciation of the U.S. dollar between 1982 and 1986 increased the competitive position of exporters to the U.S. market at the expense of U.S. domestic producers and also led to a decline in the growth of many U.S. exports.

The sharp rise in the U.S. trade deficit and in the degree of import penetration virtually across the spectrum of U.S. industries quickly emerged as a political issue in the U.S. Congress and Senate. The trade deficit was viewed much more as a problem of unfair trading practices adopted by U.S. trade partners rather than as a symptom of an inappropriate monetary-fiscal policy mix by the United States. Consequently much of the legislative focus was on trade retaliation, especially with regard to countries running large trade surpluses with the United States.

Exacerbating the problem of import competition for the U.S. resources sector was the sharp fall of many international primary product prices after 1979. Increased foreign competitiveness in U.S. markets at the same time that economic returns in the resource industry were falling led to significant reductions in profits, production, and employment in many U.S. resource industries, including softwood lumber.

However, the softwood lumber industry at this time was uniquely positioned to exert political pressure to achieve some degree of protection from Canadian imports. Senators and congressmen from timber-producing states in the U.S. South, Mountain States, and Pacific Northwest were heavily represented in certain important committees, such as the Senate Finance Committee. These committees provided politicians from hard-pressed timber-producing states both with a highly visible platform for publicizing the plight of the U.S. softwood lumber industry and, perhaps more importantly, with the means of exerting influence on behalf of the industry to achieve some degree of protection from Canadian imports.

Unfortunately, structural factors are also at work which will probably lead to continued pressures for protection of domestic U.S. resource industries in the future. Increasingly the U.S. is becoming a high-cost producer of natural resources. Depletion, declining quality of the remaining renewable and non-renewable resource bases, and increasingly stringent environmental and conservation regulatory practices have all combined to increase production costs in the U.S.

resource and resource-processing sectors including forest products. Moreover, the pace of technological change in the resource sectors has tended to be labour-saving; thus employment in certain resource industries (such as sawmills, for example) has declined absolutely and will unlikely achieve levels existing in the late 1970s.

The increasing inability of domestic U.S. resource industries to meet import competition, combined with the consequences of technological change for employment, will continue to lead to further economic dislocation in American regions dependent on resources for employment and income. The political pressure for special protection for hard-pressed single-industry communities and regions is likely to continue unabated in the future. Thus U.S. industries such as fishing, softwood lumber, uranium, and potash, to name just the more visible, will continue to press vigorously for additional protection in the future, with the intensity of their efforts dependent on cyclical factors discussed earlier.

One remarkable aspect of the entire Softwood Lumber dispute was the failure to address the basic economic issues at stake. The fundamental question is whether the increase in Canada's market share of U.S. softwood lumber consumption between 1982 and 1986 was the result of market factors (such as the appreciation of the U.S. dollar, and the superior productivity and lower cost structure of Canadian mills relative to their U.S. competitors) or whether the timber allocation and pricing policies of the Canadian government provided the Canadian industry with an unfair advantage.

The available evidence strongly supports the view that it was primarily market factors such as the exchange rate and the superior productivity of Canadian mills that were responsible for the increase in Canadian softwood lumber exports. The allegation that Canadian timber was "underpriced" is based on a misleading comparison of the price of standing timber between roughly comparable regions of the United States and Canada. At least in the case of British Columbia and the U.S. Pacific Northwest, once differences in the quality of timber, species mix, the institutional environment, and distance from markets are taken into account, much of the difference in standing timber prices is removed.

There is some evidence that the British Columbia government does fail to capture all of the returns to the forest base, but the magnitude is certainly not as large as alleged by the U.S. Coalition for Fair Lumber Imports. Moreover, it is difficult to determine from the available evidence whether the failure to capture these returns to the forest base actually leads to an expansion of softwood lumber production and exports to the United States. The "leakage" of those returns may simply lead to a redistribution of income from the Crown

to the forest industry with no corresponding impact on production levels.

The economic issues at stake in the Softwood Lumber dispute are fundamental to understanding the determinants of the pattern of Canada-U.S. trade in natural resources and processed resources. Many Canadian resources are Crown-owned and managed. Thus, the relative importance of Crown resource pricing and allocation policies *vis-à-vis* market forces derived from exchange rates, resource endowments, productivity levels, and non-resource production costs is going to be a continuing issue in Canada-U.S. trade disputes in the resources sector. Unfortunately the Softwood Lumber dispute and its resolution failed to address this issue directly nor make its relevance known to the public.

Perhaps most ominous from the perspective of Canada is the increasing use by U.S. industry pressure groups of U.S. trade remedies as a vehicle for harassing foreign competitors in the U.S. market. The popular perception, even within Canada, that bodies such as the International Trade Commission (ITC), and the International Trade Administration (ITA) are arm's-length from political pressure, or at least from the congressional view of trade policy, is simply not correct. The pressure from Congress for increased protection undoubtedly has an influence on the deliberations and findings of the ITA and ITC.

The economic issues involved in each stage of the countervail process, as in the case of Softwood Lumber, are complex. Yet several factors virtually preclude any reasonable level of analysis of the economic issues at stake. The time frame in each stage of the process is very tight and set by U.S. law; responding to an allegation of subsidy requires a significant amount of research and documentation by respondents in a very short period of time. Moreover, the onus is on the respondents in countervail proceedings to provide evidence refuting the allegation of subsidy by the petitioner. An added complication is that it is only the foreign industry's cost structure that is under review; the level of subsidies received by the U.S. domestic industries is not relevant to the process. These factors, combined with the increasing tendency for political rather than economic concerns to dominate the quasi-judicial proceedings, mean that it is very difficult for Canadian firms or industries in high-profile disputes to argue their cases successfully.

The preliminary determination by the ITA in October 1986 in the Softwood Lumber dispute illustrates the extent to which legal and economic concepts have been stretched to achieve a desired political outcome. The findings of specificity and preferentiality appear contrived to arrive at a target level of duty acceptable to both parties in the dispute – low enough not to cause serious harm to the Canadian

producers but high enough to provide some degree of protection to the U.S. industry.

The economic reasoning underlying the preliminary determination is seriously flawed. The decision suggests that any use of the sovereign right of Canadian governments to set terms and conditions of access to Crown resources justifies the finding of specificity for the program or policy under investigation in countervail proceedings. The view of the role of government in resource management embodied in the ITA determination is simplistic in the extreme. Discretion per se rather than targeting seems to be the issue at stake. Yet the reality is that government intervention or so-called "exercise of discretion" in resource markets is pervasive in many countries and rightly so because of market failure. Indeed, any owner of private property in North America has a wide discretion over its sale. Discretion is axiomatic to ownership.

The ITA also treated the forest products industry as a single industry and argued that vertical integration required that the wood products and pulp and paper industries be treated as a single industry. Such reasoning is very difficult to justify, as the notion of industry definition usually calls for consideration of factors relating to production technologies and characteristics of market demand. This approach, however, made it possible for the ITA to determine that Crown timber-allocation policies were industry specific. Perhaps more importantly, the preliminary determination has implicitly found the pulp and paper industry guilty of using a subsidized input – "underpriced" Crown timber – without letting the industry offer a defence.

Perhaps the most glaring error in the preliminary determination was the double counting of the value of the timber base. The procedure adopted by the ITA in calculating the magnitude of the subsidy (if any) once specificity was determined was virtually guaranteed to ensure that a positive value of subsidization would be found. The procedure involved imputing an "intrinsic value" to the timber harvested and adding this to actual expenditures undertaken by provinces in managing the forest base. However, this "intrinsic value" imputation will be very close in value to the revenues received by the Crown if Crown timber-valuating policies are reasonably accurate. Thus, subtracting expenditures on the forest base (inclusive of the imputation) from forest base revenues – taxes, royalties, etc. – will always make it appear that government expenditures on the forest base (a misleading estimate of "production costs") exceed forest revenues.

The contrived and ad hoc nature of the ITA's preliminary determination clearly indicated that the final ruling was likely to be decided on the political rather than economic merits of the case. The

Understanding can be rationalized on pragmatic grounds as the best that Canada could do in light of the increasing protectionist sentiment in the United States and the political dimensions of the case. It was seen as more desirable to keep the tax revenues in Canada through an export tax rather than have them accrue to the U.S. Treasury through imposition of a countervailing duty. Unfortunately, the Understanding is utterly deficient in terms of defining the economic merits of the case. The key issue – whether market forces brought about by exchange rate movements and industry productivity account for increased Canadian penetration of the U.S. market or whether the cause lies in timber-pricing policies – is neglected entirely. The Understanding explicitly states in the General Provisions (item 3(b)):

> This understanding is without prejudice to the position of either government as to whether the stumpage programs and practices of Canadian governments constitute subsidies. . . .

Yet the Understanding *implicitly* treats the allegation of subsidy as correct. Otherwise, the Understanding would not have as its ultimate objective an increase in stumpage fees and other charges to a level equivalent to the 15 per cent *ad valorem* tax.

Policy Implications

Officials of Canadian resource industries and government policy-makers must, in the aftermath of what can only be described as a disappointing defeat in the Softwood Lumber dispute, assess once more the long-term implications of doing business with the United States. This reassessment should now, if it did not before, take into account several well-established reference points. First, U.S. trade policy is not anchored in objective economic analysis. Canadians should not waste their energies debating whether their programs amount to subsidies in accordance with economic principles unless both countries can agree on the economic principles they will adhere to in determining subsidy. Second, the quasi-judicial process of resolving trade disputes, which ostensibly gave Canadian industry their day in court during the investigating phase of the Softwood Lumber dispute, should not be assumed to be impartial and immune to political pressures. In other words, sound economic and legal arguments do not necessarily guarantee Canadian industry unimpeded access to the U.S. market. Rather than relying on such arguments, it would seem sensible to adopt the view that legal harassment is a long-term cost of doing business in the United States and that the energies of Canadian industry and government officials

should be devoted to coping with, and minimizing if possible, these long-term costs. If any Canadian industry is interested in increasing its market share in the United States, it should build into its long-term business plan a method of handling the costs associated with fighting protectionist measures.

The Softwood Lumber dispute and its resolution have two basic implications for Canada-U.S. free trade negotiations. The first is that the term "free trade" is a complete misnomer for the process. Canada and the United States have for some time been embarking on a course of "managed" trade. This process has been accomplished by the application of U.S. contingent-protection laws and through the efforts of Canadian industries to avoid their application. It is clear that once a Canadian industry increases its market share in the United States, the formidable array of U.S. contingent-protection mechanisms will be brought to bear on it. As noted earlier, the definitions of "subsidy" and "injury" employed by quasi-judicial trade bodies have become sufficiently flexible that they can accommodate virtually any petition initiated by U.S. industry groups. Canadian industries are thus very aware that continued access to the U.S. market depends critically on not exceeding some implicit or explicit market share. That market forces are responsible for shifts in market share does not appear to be a sustainable defence before the ITC and the ITA, at least in politically visible cases such as softwood lumber.

The second implication of the Softwood Lumber dispute is that any free trade agreement with the United States must include provisions for a trade-dispute tribunal that supersedes the application of U.S. contingent protection. In the absence of such a body, if a free trade agreement were negotiated and Canadian firms took advantage of unhindered access to the U.S. market, it is highly likely that U.S. industry groups would respond with an onslaught of suits under "escape clause" (Section 201) or market disruption provisions, unfair government trading practices, or countervail proceedings. The potential gains to Canadian firms from access to the United States would not be realized or would be dissipated in legal actions before U.S. trade bodies. The cost of the current Softwood Lumber dispute to the Canadian industry, just for legal and consulting fees, has been estimated at about $11 million. These costs do not include time costs of senior management or those of officials of federal and provincial governments involved in the dispute. At present, U.S. trade remedies are applied in order to harass Canadian exporters; certainly this would occur with even greater frequency in a free trade agreement with no provisions for a mechanism to settle disputes.

Abrégé

La question

En mai 1983, la question des tarifs compensatoires sur l'exportation du bois d'oeuvre canadien aux États-Unis semblait avoir été résolue une fois pour toutes. Le ministère du Commerce des États-Unis s'était aperçu que les politiques du Canada relatives à la fixation des prix et à l'allocation des récoltes de bois ne constituaient pas une prime à l'exportation compensatoire pour l'industrie du bois d'oeuvre. Il s'était avéré que le bois d'oeuvre des terres de la Couronne était disponible aux mêmes conditions, quels que soient l'industrie ou l'acheteur, et qu'il n'était pas fourni à des taux préférentiels aux producteurs de bois d'oeuvre. Les politiques du Canada relatives à la fixation des prix et à l'allocation répondaient par conséquent aux critères des tests du ministère du Commerce sur la "disponibilité générale" et le caractère préférentiel, dans le cadre de l'enquête sur les soi-disant pratiques de primes à l'exportation. Afin de satisfaire aux exigences des tests, le ministère du Commerce avait dû rejeter l'imposition de tarifs compensatoires sur le bois d'oeuvre canadien.

En mai 1986, la Coalition américaine pour une réglementation équitable de l'importation du bois d'oeuvre a déposé une pétition auprès de la Commission du commerce internaional, alléguant que les politiques relatives à la fixation des prix et à l'allocation constituaient une prime à l'exportation compensatoire, et réclamant qu'un droit de 27 pour cent soit imposé sur les importations de bois d'oeuvre du Canada. Les preuves fournies par la Coalition n'étaient pas bien

différentes de celles présentées au cours du différend de 1982-83. De plus, ni la loi ni les faits n'avaient été modifiés pendant ce laps de temps. Le seul changement remarquable était que la portion de bois d'oeuvre pour la consommation domestique des États-Unis figurant sur les registres des importations du Canada était passée de 28,5 pour cent en 1983 à 31,6 pour cent en 1985.

En octobre 1986, le ministère du Commerce est revenu sur sa conclusion et, dans une conclusion préliminaire, a trouvé que les politiques relatives à la fixation des prix et à l'allocation constituaient une prime à l'exportation compensatoire. De plus, les critères opérationnels employés par le ministère du Commerce dans son évaluation de la disponibilité générale et du caractère préférentiel des soi-disant pratiques de primes à l'exportation étaient devenues trop ouverts et trop flexibles, et ils étaient basés sur une théorie économique si mal fondée que, pour les pays exportateurs vers les États-Unis de produits bruts ou ayant subi une transformation industrielle, pratiquement n'importe quelle politique gouvernementale relative à la gestion des ressources naturelles pouvait être considérée comme étant compensatoire.

Le gouvernement canadien, qui s'attendait à ce que la conclusion finale confirme les constatations préliminaires et éventuellement impose un tarif compensatoire encore plus élevé que celui recommandé dans la conclusion préliminaire, a accepté, à la fin de décembre 1986, d'imposer un droit d'exportation de 15 pour cent ad valorem sur le bois d'oeuvre destiné aux États-Unis. En contrepartie, les procédures compensatoires aux États-Unis ont été supprimées.

Le mémorandum d'entente entre le Canada et les États-Unis, qui a mis fin au différend concernant le bois d'oeuvre (et qui plus tard a été promulgué loi par le parlement canadien), est un fait historique dont les implications sont énormes pour l'industrie canadienne des ressources forestières en particulier et pour les industries canadiennes des ressources naturelles en général.

Objectifs de base de l'étude

La présente étude a été motivée par trois objectifs de base. Le premier consistait à déterminer si l'épisode 1986 du différend au sujet du bois d'oeuvre était un exemple isolé, quoiqu'important, de différend commercial entre le Canada et les États-Unis, découlant de certaines pressions politiques et économiques à court terme et de caractéristiques spécifiques à l'industrie du bois d'oeuvre. Ou bien était-ce la preuve d'un problème à plus long terme dérivé de facteurs structuraux, et par conséquent à même d'affecter toute une variété d'industries canadiennes comptant sur le marché américain? Le second objectif de l'étude était d'évaluer les preuves disponibles de

deux séries de facteurs: le niveau des coûts relatifs et la dotation en ressources d'une part, et les subventions explicites et implicites accordées aux producteurs de bois d'oeuvre canadiens d'autre part, pour expliquer la tendance actuelle du commerce du bois d'oeuvre entre le Canada et les États-Unis. Le dernier objectif était d'examiner la manière dont des éléments de ce cas avaient été évalués par des organismes commerciaux américains parajudiciaires soi-disant impartiaux, tels que l'Administration du commerce international et la Commission du commerce international.

Résumé et conclusions

A l'issue de cette étude de l'épisode 1986 du différend au sujet du bois d'oeuvre, les auteurs sont pessimistes à l'égard de l'avenir à long terme des relations commerciales Canada/États-Unis, surtout dans le domaine des produits naturels bruts ou ayant subi une transformation industrielle. Le différend au sujet du bois d'oeuvre a été en partie le reflet d'un certain nombre de facteurs à court terme qui se sont produits simultanément. Il est fort peu probable que cette situation se reproduise un jour, tout au moins avec la même ampleur. L'augmentation importante de la valuer du dollar américain entre 1982 et 1986 a favorisé la concurrence des exportateurs vers les marchés des États-Unis, au détriment des producteurs domestiques américains. Elle a également été la cause de la baisse de nombreuses exportations américaines.

L'augmentation brutale du déficit commercial américain et des importations qui ont pénétré dans pratiquement tous les domaines de l'industrie américaine est vite devenue une question politique débattue au Congrès américain et au Sénat. Le déficit commercial a été perçu comme étant causé par des pratiques commerciales inéquitables adoptées par les partenaires commerciaux des États-Unis, plutôt que comme le symptôme d'une politique monétaire-fiscale inappropriée des États-Unis. Ce qui explique les mesures de représailles commerciales, en particulier à l'égard de pays qui écoulent d'importants excédents vers les États-Unis.

La baisse brutale, après 1979, des prix internationaux de nombreuses matières premières, n'a fait qu'amplifier la concurrence à l'importation de ressources naturelles vers les États-Unis. Cette intensification de la concurrence étrangère sur les marchés américains, au moment où les revenus de l'industrie des ressources naturelles étaient en baisse, a eu pour résultat une baisse importante des profits, de la production et de l'emploi dans de nombreuses industries de ressources américaines, y compris celle du bois d'oeuvre.

Toutefois, l'industrie du bois d'oeuvre occupait à ce moment-là une position-clé pour exercer des pressions politiques en vue

d'acquérir un certain degré de protection contre les importations canadiennes. Les sénateurs et les représentants au Congrès des états producteurs de bois du Sud, des Rocheuses et du Pacifique du Nord-Ouest étaient nombreux dans les comités importants, tels que le Comité des finances du Sénat. Pour les politiciens représentant les états producteurs de bois dans la gêne, ces comités constituaient un podium bien en vue, d'où ils pouvaient publiquement parler du triste état dans lequel se trouvait l'industrie du bois d'oeuvre. Ils leurs permettaient également d'exercer une grande influence, au nom de l'industrie, afin d'acquérir un certain degré de protection contre les importations canadiennes.

Malheureusement, certains facteurs structuraux entrent également en jeu. Il en résultera probablement des pressions continues, à l'avenir, pour la protection des industries de ressources domestiques américaines. Les États-Unis deviennent, d'une manière croisssante, des producteurs de ressources naturelles à prix de revient élevé. L'épuisement des ressources, la baisse de la qualité des ressources renouvelables et non-renouvelables restantes, ainsi que les réglements rigoureux pour la protection de l'environnement et la conservation, sont cause de l'augmentation des prix de revient de la production des ressources et de l'industrie de traitement des ressources aux États-Unis, y compris l'industrie forestière. De plus, le rythme rapide des changements technologiques dans le secteur des ressources tend à produire des économies de main-d'oeuvre; l'emploi dans certaines industries de ressources (par exemple les moulins à scie) a souffert considérablement et n'atteindra jamais plus le niveau qu'il avait dans les années soixante-dix.

Les industries de ressources domestiques américaines étant de plus en plus incapables de faire concurrence aux importations, et les changements technologiques ayant de tels effets sur l'emploi, la situation économique ne pourra que continuer à se détériorer dans les régions américaines dont l'emploi et les revenus dépendent des ressources naturelles. Les pressions politiques visant l'établissement d'une protection spéciale pour les communautés et les régions dans la gêne qui n'ont qu'une seule industrie ont toutes les chances de continuer au même rythme à l'avenir. C'est pourquoi les industries américaines telles que la pêche, le bois d'oeuvre, l'uranium et la potasse, pour ne nommer que les plus visibles, continueront à lutter vigoureusement pour obtenir des mesures de protection supplémentaires à l'avenir. L'intensité de leurs efforts dépendra des facteurs cycliques dont on a parlé plus haut.

Dans le différend au sujet du bois d'oeuvre, il est remarquable de noter que les questions économiques en jeu n'ont jamais été réellement traitées. La question fondamentale est de savoir si l'augmentation de la portion canadienne de consommation de bois

d'oeuvre aux États-Unis entre 1982 et 1986 a été le résultat de facteurs du marché (tels que l'augmentation de la valeur du dollar américain, ainsi que la productivité accrue et les coûts moins élevés des scieries canadiennes par rapport à leurs concurrents américains), ou bien si les politiques du gouvernement canadien relatives à la fixation des prix et à l'allocation du bois ont favorisé inéquitablement l'industrie canadienne.

Les preuves à notre disposition démontrent que ce sont principalement des facteurs du marché, tels que le taux d'échange et la productivité accrue des scieries canadiennes, qui sont responsables de l'augmentation des exportations du bois d'oeuvre canadien. L'allégation que le bois canadien a été "vendu moins cher qu'il ne valait" est basée sur une comparaison, qui a créé une fausse impression, des prix du bois sur pied entre des régions plus ou moins comparables des États-Unis et du Canada. Au moins dans le cas de la Colombie-Britannique et des états du Pacifique du Nord-Ouest, lorsqu'on tiend compte des différences dans la qualité, le mélange des espèces, l'environnement institutionnel et la distance jusqu'aux marchés, il n'y a pratiquement plus de différence entre les prix du bois.

Nous avons la preuve que le gouvernement de Colombie-Britannique ne perçoit pas tous les revenus de l'industrie forestière auxquels il a droit, mais pas dans les proportions que prétend la Coalition américaine pour une réglementation équitable de l'importation du bois d'oeuvre. De plus, il est difficile de juger, à partir des preuves à notre disposition, si la non-perception de ces revenus de l'industrie forestière est la cause réelle de l'augmentation de la production du bois d'oeuvre et des exportations vers les États-Unis. Ces "pertes" de revenus mènent peut-être à une redistribution des revenus du bois de la Couronne, sans conséquence sur le taux de production.

Il est indispensable de discerner les problèmes économiques en jeu dans le différend au sujet du bois d'oeuvre, pour comprendre l'état des rapports commerciaux entre le Canada et les États-Unis en matière de ressources naturelles à l'état brut ou ayant subi une transformation industrielle. Une grande partie des ressources canadiennes sont du domaine de la Couronne et gérées par elle. Il s'ensuit que l'importance relative des politiques de fixation des prix et d'allocation des ressources de la Couronne par rapport aux forces du marché, influencées par les taux de change, les fonds des ressources, les niveaux de productivité et les autres coûts de production, seront un facteur permanent de contestation dans les différends entre les deux pays relativement au secteur des ressources. Malheureusement, cette question n'a pas été abordée lors du différend au sujet du bois d'oeuvre

et de son règlement, et le public n'a pas été tenu au courant de son importance.

Ce qui est peut-être le plus dangereux, du point de vue canadien, c'est la tendance qu'ont les groupes industriels de pression américains à recourir de plus en plus fréquemment aux mesures commerciales compensatoires, pour contrer les concurrents étrangers sur le marché américain. L'opinion couramment admise, même au Canada, que des organismes comme l'ITC (la Commission du commerce international) et l'ITA (l'Administration du commerce international) savent garder leurs distances vis-à-vis de la pression politique ou au moins du Congrès, n'est tout simplement pas fondée. La pression exercée par le Congrès dans le sens du protectionnisme influence, sans aucun doute, les délibérations et les conclusions de ces deux organismes.

Les problèmes économiques présents à chaque étape de la procédure compensatoire, comme dans le cas du bois d'oeuvre, sont complexes. Pourtant, plusieurs facteurs empêchent virtuellement de parvenir à une analyse raisonnable de ces questions. Le temps alloué pour chaque étape de la procédure est très limité, et il est fixé par la loi américaine; pour répondre à une accusation de subvention, il faut entreprendre un long travail de recherche et de documentation, et cela doit être fait dans un laps de temps très court. En outre, la charge de la preuve incombe au défendeur: celui-ci doit réfuter l'accusation de subvention portée par le plaignant. Vient s'ajouter à cela le fait que seule la structure des coûts de l'industrie étrangère est en cause, l'importance des subventions reçues par les industries américaines n'étant pas pertinente dans ce type de procédure. Ces circonstances, jointes à la tendance croissante à laisser les préoccupations politiques prendre le pas sur l'économie, mettent les firmes et les industries canadiennes dans l'impossibilité de défendre efficacement leur cause lors de différends importants.

La conclusion préliminaire de l'ITA d'octobre 1986, dans le cas du bois d'oeuvre, illustre bien dans quelle mesure les concepts juridiques et commerciaux peuvent être sollicités pour parvenir à un résultat politiquement désirable. Les conclusions sur les charges et le caractère préférentiel paraissent avoir été mises au point pour arriver à un niveau de droits acceptable par les deux parties au litige: assez bas pour ne pas causer de sérieux dommages aux producteurs canadiens et assez élevé pour fournir un certain degré de protection à l'industrie des États-Unis.

Le raisonnement économique derrière cette conclusion est défectueux. La conclusion suggère que toute utilisation du droit de souveraineté par les gouvernements canadiens dans l'établissement des termes et conditions d'accès aux ressources de la Couronne justifie l'admission des charges contre le programme ou la politique en cours d'examen, dans la procédure compensatoire. La conception du rôle du

gouvernement dans la gestion des ressources, tel qu'elle apparaît dans la conclusion de l'ITA, est extrêmement simpliste. Le caractère discrétionnaire en soi, plutôt que l'objectif, semble être le véritable problème. Et pourtant, le fait est que l'intervention gouvernementale ou la prétendue "décision discrétionnaire" dans les marchés des ressources est pratiquée dans de nombreux pays, et à juste titre, étant donné les défauts de ces marchés. De fait, n'importe quel propriétaire privé, en Amérique du Nord, use largement d'un droit discrétionnaire lorsqu'il vend sa propriété. L'usage discrétionnaire entre dans la définition du droit de propriété.

L'ITA a aussi considéré tous les produits forestiers comme faisant partie d'une même industrie et a soutenu que l'intégration verticale demandait que les produits du bois et les industries de pâte à papier soient traités comme appartenant à une seule et même industrie. Un tel raisonnement est difficile à suivre, étant donné que la définition d'une industrie fait habituellement appel aux critères de technologie de production et aux caractéristiques du marché de la demande. Cette attitude a cependant permis à l'ITA de conclure que les politiques d'allocation des coupes de la Couronne devaient être jugées dans le contexte de l'industrie. Mais ce qui est peut-être plus important encore, c'est que la conclusion préliminaire a reconnu implicitement l'industrie de la pâte à papier capable d'utiliser une matière première subventionnée – le bois "sous-évalué" du domaine de la Couronne – sans permettre à l'industrie de se défendre.

Peut-être que l'erreur la plus frappante dans la conclusion préliminaire vient du fait que la valeur du bois comme matière première a été comptée deux fois. Une fois l'accusation admise, la procédure suivie par l'ITA pour évaluer l'importance de la prétendue subvention devait nécessairement amener à trouver une valeur de subvention justifiant la charge. Cette procédure envisageait l'imputation au bois récolté d'une valeur intrinsèque et l'addition à cette valeur des dépenses effectivement engagées dans la gestion forestière. L'imputation d'une "valeur intrinsèque" sera cependant très proche de la valeur des revenus perçus par la Courconne si les politiques d'évaluation des prix du bois sont raisonnablement précises. Par conséquent, la soustraction des frais de gestion forestière (y compris l'imputation) des revenus forestiers de base – taxes, royalties, etc. – fera toujours apparaître un excédent des dépenses gouvernementales de gestion (une façon trompeuse de calculer les coûts de production) sur les revenus forestiers.

La nature particulière et artificielle de la conclusion préliminaire de l'ITA laissait clairement présager que la conclusion finale s'appuierait vraisemblablement davantage sur des raisons politiques que sur les propres mérites économiques de l'affaire. On peut comprendre cette entente d'un point de vue pragmatique comme

étant le meilleur arrangement possible pour le Canada, étant donné la faveur de plus en plus grande que le protectionnisme rencontre aux États-Unis et les dimensions politiques de l'affaire. On a jugé qu'il était préférable de garder les revenus au Canada au moyen d'une taxe à l'exportation, plutôt que de courir le risque de voir le Trésor américain en profiter, grâce à des droits de douane compensatoires. Malheureusement, l'entente est totalement insuffisante dans son analyse des mérites économiques de l'affaire. La question-clé, à savoir si le succès du Canada sur le marché américain est dû aux fluctuations des taux de change et à la productivité de l'industrie, ou bien s'il provient des politiques de fixation des prix, est entièrement laissée de côté. L'entente stipule expressément, dans les clauses générales, que (article 3(b)):

> Cette entente est établie sans préjudice de la position respective des deux gouvernements sur la question de savoir si les programmes de coupe et les pratiques des gouvernements canadiens constituent des subventions. . .

Pourtant, l'entente reconnaît implicitement l'accusation de subvention, autrement elle n'aurait pas comme objectif final une augmentation des droits de coupe et autres charges jusqu'à concurrence de 15 pour cent ad valorem en taxation.

Conséquences en matière politique

Au lendemain de ce qui peut simplement être qualifié d'échec décevant dans le différend au sujet du bois d'oeuvre, les responsables des industries de ressources et du gouvernement devront une fois de plus évaluer toutes les implications à long terme qu'entraînent nos relations d'affaires avec les États-Unis. Cette réévaluation devrait maintenant prendre en compte, si cela n'a pas été fait dans le passé, plusieurs données fondamentales. D'abord, le fait que la politique commerciale américaine ne se fonde pas sur une analyse économique objective. Les Canadiens ne devraient pas gaspiller leur énergie à déterminer si oui ou non leurs programmes comportent des subventions conformes aux principes économiques, aussi longtemps que les deux pays ne se seront pas mis d'accord sur les principes économiques qui serviront de critères pour définir les subventions. Ensuite, la procédure parajudiciaire utilisée pour le règlement des différends commerciaux, qui a soi-disant donné au Canada la possibilité de s'exprimer devant un tribunal au cours de l'enquête menée sur le différend au sujet du bois d'oeuvre, ne devrait pas être présumée impartiale ni insensible aux pressions politiques. En d'autres termes, les arguments juridiques et économiques solides ne

garantissent pas à l'industrie canadienne le libre accès au marché américain. Plutôt que de se reposer sur de tels arguments, il serait plus réaliste de se rendre compte que les tracasseries juridiques sont le prix à long terme qu'il faut payer pour faire des affaires aux États-Unis, et que les efforts conjugués de l'industrie et de l'administration canadiennes devraient se concentrer sur les moyens de régler, et si possible de minimiser, ces coûts à long terme. Toute industrie canadienne qui envisage d'accroître sa part du marché américain devrait prévoir, dans son plan d'affaires à long terme, une procédure capable de tenir compte des frais à encourir pour combattre les mesures protectionnistes.

Le différend au sujet du bois d'oeuvre, ainsi que son réglement, ont deux conséquences fondamentales pour les négociations américano-canadiennes sur le libre-échange. La première est que le terme "libre-échange" n'est pas approprié dans ce cas. Depuis un certain temps, les deux pays sont engagés dans un processus d'échange "contrôlé". Ce processus a commencé avec la mise en application des lois de contingentement américaines et les efforts déployés par les industries canadiennes pour en éviter les effets. Il est évident que chaque fois qu'une industrie canadienne augmentera sa part de marché aux États-Unis, le formidable mécanisme du système protectionniste de contingentement américain se déclenchera pour essayer de la contrer. Comme indiqué précédemment, les définitions de "subvention" et de "dommage" utilisées par les organismes commerciaux parajudiciaires sont devenues assez souples pour servir de prétexte à virtuellement n'importe quelle plainte formulée par des groupes industriels américains. Les industries canadiennes sont donc pleinement conscientes du fait que l'accès permanent au marché américain est une question d'équilibre: il ne faut pas excéder la part du marché qui a été implicitement ou explicitement reconnue. Le fait que les forces du marché soient responsables des changements dans la part occupée sur le marché ne semble pas être une défense valable devant l'ITC et l'ITA, au moins dans les affaires politiques voyantes comme celles du bois d'oeuvre.

La seconde conséquence résultant du différend au sujet du bois d'oeuvre est que toute entente commerciale avec les États-Unis doit inclure des clauses relatives à l'établissement d'un organisme chargé du contentieux commercial qui puisse remplacer le système américain de protection commerciale par contingentement. Si une entente commerciale intervenait sans que soit constitué un tel tribunal, il est probable que toute firme canadienne qui entendrait bénéficier de cet accord pour s'installer sur le marché américain se verrait rapidement assaillir de procès par les groupes industriels américains, au titre de "la clause d'évasion" (section 201) ou des clauses sur la rupture du marché, sur les pratiques commerciales gouvernementales

inéquitables, ou bien encore sur les procédures compensatoires. Les gains potentiels, pour les firmes canadiennes, ne se matérialiseraient pas ou seraient gaspillés en frais de procès devant les organismes commerciaux américains. On a estimé que, pour régler le différend au sujet du bois d'oeuvre, les frais juridiques et les honoraires de consultation, à eux seuls, ont coûté à l'industrie canadienne environ 11 millions de dollars. Ces frais ne comprennent pas les coûts du temps passé par les cadres supérieurs et les responsables des gouvernements fédéral et provinciaux pour le règlement de ce différend. A l'heure actuelle, les mesures commerciales compensatoires américaines servent à harceler les exportateurs canadiens; une entente de libre-échange qui ne prévoirait pas de mécanisme spécial pour régler les différends ne pourrait que favoriser l'accentuation de cette tendance.

Chapter 1:

Introduction

The Issue

Trade in natural resources and processed resource products is becoming an increasingly contentious issue in U.S. trade policy. In the U.S. market for unprocessed and processed resource products, the share held by foreign exporters has increased, especially during the early 1980s. The rise in market share accounted for by imports has led U.S. domestic producers and their interest groups to work for more favourable (ie., restrictive) interpretations of existing trade laws and for new legislation which would afford greater protection against imports. Congressmen and senators from resource-based regions of the United States have entered the debate on the side of domestic producers. The rise in foreign market share has been associated with stagnant or declining levels of employment and investment in many resource-based industries. Concern for the economic viability of single-industry communities, and in some instances of large regional economies, has made U.S. politicians respond favourably to the protectionist sentiments of domestic resource producers. Canada, with its large volume of unprocessed and processed resource trade with the United States, will be adversely affected by the emergence of any additional tariff or non-tariff barriers to trade in resource products.

The rise in U.S. market share held by foreign resource producers can be explained by two basic sets of factors. The first set derives from the operation of market forces and explains the observed pattern of

trade as the consequence of differences between the United States and its trading partners in the quantity and quality of natural resource endowment and in costs of extraction and processing. Augmenting the influence of these factors of comparative advantage are others relating to the market, such as exchange rates and differing rates of growth in industry productivity.

The U.S. dollar has appreciated relative to other currencies such as the Canadian dollar and the Mexican peso. The rise in the value of the U.S. dollar has improved the competitive position of resource exporters from other countries (especially Canada and Mexico) within the U.S. market. It has also hampered the ability of U.S. resource exporters to compete with other countries in the international market. It has thus contributed to the large deficit in merchandise trade experienced by the United States in recent years.

The United States is also becoming an increasingly high-cost producer of unprocessed and processed resource products. Both renewable and non-renewable resource sectors face constraints on resource supply, exacerbated in some cases by government restrictions on resource exploitation; these have led to a rising cost structure for major resource industries in the United States.

The second set of factors advanced to explain foreign inroads on the U.S. market consists of the "unfair" advantages that foreign resource exporters are said to have in the U.S. market. This is a view advocated by domestic producers and apparently believed by a number of U.S. congressmen and senators. It is claimed that foreign resource producers receive a variety of subsidies which enhance their competitive position in the U.S. market. These alleged subsidies can even take the form of expenditures on regional development strategies directed at maintaining employment and investments in targeted regions or sectors. In the case of fish exports from the Canadian Maritimes, for example, the benefits received directly and indirectly from such programs by Maritime fishermen and fish processors were held to be subject to countervailing duty.

Increasingly the focus, especially in the U.S. Congress, has turned to the alleged "underpricing" of natural resources from countries such as Mexico and Canada. It is claimed that the ability of resource processors to expand their market share in the United States is not the result of more and better natural resources and lower production costs – that is, comparative advantage. Rather, it is alleged that government pricing policies for resources in the public domain, combined with restrictions on the export of unprocessed natural resources, constitute an "upstream" or "resource input" subsidy to resource processors. Thus the focus of debate and the emphasis of proposed U.S. legislation is more on the pricing of the resource inputs and less on the price of the processed export. The

policies adopted by governments for pricing natural gas in Mexico and timber in British Columbia have come under particular scrutiny and are claimed to have led to unfairly large exports of petrochemicals and softwood lumber, respectively, to the United States.

The Ninety-ninth U.S. Congress was particularly active in attempting to define legislatively the appropriate benchmark for evaluating the prices of natural resource inputs in foreign resource-processing industries. The chronology provided in Appendix A contains some of the bills dealing with resource pricing introduced in the ninety-ninth and earlier congresses. None of these bills was enacted but the constant recurrence of similar bills in subsequent sessions indicates that the issue remained very much alive. The proposed legislation was aimed at policies adopted by some foreign governments pricing natural resources through two-tier pricing schemes – high export prices and low internal-use prices. These policies were claimed to discriminate against U.S. resource processors by denying them access, in some cases, to low-cost resource inputs, while providing these inputs at low cost to domestic producers for export to the United States. Foreign resource prices in this scenario were seen to derive from government pricing decisions rather than to reflect the consequences of comparative advantage and market forces.

Concern over pricing of resource inputs did not die with the end of the 99th Congress in October 1986. The House of Representatives of the 100th Congress has passed the Trade and International Economic Policy Reform Act of 1987 (H.R. 3) with provisions specifically directed at foreign resource-pricing policies. The report of the House Ways and Means Committee accompanying H.R. 3 (U.S. 1987, 124-27) discusses criteria that should be employed by quasi-judicial trade bodies when evaluating foreign resource-pricing policies.

The first benchmark discussed is the free market price of the item in the exporting country. However, the report notes that government pricing policies might distort prevailing private market prices, especially in the case where the government is the dominant seller. Consequently, in the absence of "undistorted" market prices, the second benchmark the U.S. Department of Commerce is instructed to consider are external prices such as "... freely available, market determined export prices for such or similar goods; or the freely available, market determined rate for such or similar goods or services in another country if Commerce finds that such external market resembles the market in question" (U.S. 1987, 125).

The report acknowledges that a country's comparative advantage may lead it to be a low-cost producer relative to the United States and suggests that "to the extent that such advantages could be demonstrated and quantified, the administrative authority would

have discretion to adjust the selected benchmarks . . ." (U.S. 1987, 126.). However, this view is qualified by noting that a government that is a dominant seller may through its policies or pricing practices distort export prices.

The final benchmark discussed in the House Ways and Means report is the "cost of producing the good or service and including a reasonable profit which would be consistent with commercial considerations . . ." (U.S. 1987, 126). Interestingly this benchmark had previously been chosen by the International Trade Administration of the Department of Commerce (ITA) in its determination of subsidy in the Softwood Lumber case on October 16, 1986. Thus, increasingly, U.S. trade legislation is concerned with determining whether foreign resource prices are "too low" and with setting out benchmarks to assess the degree of preferentiality afforded to domestic resource processors.

The perception in the United States that the existing pattern of trade in natural resources and processed resources reflects unfair advantages on the part of foreign exporters has serious implications for Canada. Canada is a large exporter of both unprocessed and processed resource products to the United States and unhindered access to the U.S. market is critical to the viability of resource industries in a number of regions in Canada, especially the West. In 1984, for example, of Canada's total domestic merchandise exports of $109.5 billion, 75.6 per cent went to the United States. Nearly 50 per cent of Canada's exports to the United States were either natural resources or processed resources; wood and paper product exports alone amounted to $11.2 billion (Statistics Canada 1984).[1] The economic position of Western Canada is particularly vulnerable to increasing U.S. protectionism in the area of trade in resources. Although only 64 per cent of Western Canada's exports were destined for the United States in 1985, this flow was composed overwhelmingly of resource-based products. Petroleum products accounted for 28 per cent of Western Canadian exports to the United States; forestry, 21 per cent; natural gas, 14 per cent; chemicals, 13 per cent; grains, 2 per cent; food, 2 per cent; sulphur, 1 per cent; livestock, 1 per cent; "other," 13 per cent (Canada West Foundation 1986b).

The Softwood Lumber dispute has, to date, received the most public attention as an indicator of tension in bilateral Canada-U.S. trade in resources. However, there are a number of other resource-based industries that appear to face the same protectionist pressures as softwood lumber. The pulp and paper industry is a case in point. The allegation that stumpage, or the value of standing timber, from provincial Crown lands is subsidized and therefore constitutes an upstream subsidy to the softwood lumber industry is equally applicable to the pulp and paper industry. Both industries use timber

from Crown lands as a primary input, although in the case of the pulp and paper industry woodchips from the wood products industry are also an important input.

The uranium industry also appears to be in for a rough ride.[2] In 1985 Canada was the largest producer of uranium in the western world, providing about 31 per cent of the world's natural uranium. Close to half of Canada's exports went to the United States. Uranium producers in the United States have alleged that Canadian companies receive more favourable treatment from banks and the government than their U.S. counterparts do. A political pressure group similar to that which proved so successful in softwood lumber appears to be emerging in the case of uranium. Senator Peter Dominici, a Republican from New Mexico, and senators from Wyoming and Utah, also uranium-producing states, are becoming increasingly visible as advocates of import restrictions on Canadian uranium.

The potash industry is another likely candidate to face protectionist pressures in the U.S. market. Saskatchewan's production costs for potash are among the lowest in the world because of favourable geology (Olewiler 1986, 8). Operating costs per tonne for potassium chloride produced in Saskatchewan were estimated (in 1978 dollars) to lie in the range of $14 to $16 compared to $22 to $24 for U.S. producers (Olewiler 1986, 9). Saskatchewan producers have accounted for over 70 per cent of total potash consumption in the United States (Olewiler 1986, 6). Because of depletion and lower quality grades, the New Mexico industry has a high cost structure; combined with slumping agricultural demand for fertilizer, this has led it to face a fall in revenues and production during the 1980s.[3] The Potash Corporation of Saskatchewan, a provincial Crown corporation, is a major player in the North American market for potash.[4] Focusing on Crown pricing strategies and discretion in resource allocation with respect to potash, industry and political interest groups in the United States can and have raised many of the same arguments as those that proved successful for U.S. producers in the Softwood Lumber dispute.

Restrictions on access to the U.S. market need not take the form of countervailing duties or the application of other U.S. trade remedies. A regulatory authority of quasi-judicial bodies, such as the Federal Energy Regulatory Commission (FERC), can also erect significant barriers to access to the U.S. market. For example, on December 3, 1986, in a 5 to 0 decision, FERC disallowed the pass-through of most Canadian pipeline transmission costs to U.S. customers. The commission ruled that Canadian and U.S. gas transportation costs must be billed the same way – using U.S. rules (*Globe and Mail* 1986e). The only option open to Canadian producers to recoup their fixed transportation costs is to raise the selling price of their gas. The U.S. natural gas market is depressed, so any effort by

Canadian producers to pass on these higher charges directly to consumers will lead to lost sales. One estimate is that the FERC decision may cost Canadian gas exporters $450 million in lost revenues. Thus U.S. regulatory agencies need not accept and often do not follow Canadian regulatory practices.

The chairman of FERC argued that "the Commission voted on this order based on a firm belief that the playing field between domestic and Canadian producers ought to be even . . ." (*Globe and Mail* 1986d). The notion of a "level playing field" which U.S. trade representatives often refer to in the context of Canadian-U.S. trade relations means, at least in this instance, that both Canadian price *and* pricing mechanisms must correspond to U.S. ones.

Protectionist Trends in the United States

The 1980s have seen a significant increase in both protectionist rhetoric and initiatives in the United States. The issue of trade relations has become an important focus of congressional activity. In 1985, for example, the first year of the Ninety-ninth Congress, there were 634 trade bills introduced, of which 99 could be classified as protectionist in intent and effect; a further 51 bills were directed at adjusting tariffs upward, 77 would make it easier to obtain quasi-judicial relief, and 109 would "restrict trade to achieve non-protectionist objectives" (Destler 1986, 75).

Many of the recent trade bills before Congress have a dual purpose – removal of perceived barriers to U.S. exports and defining the terms of access to the U.S. market. In some cases these goals are combined: the expansion of exports is promoted by making foreign access to the U.S. market contingent on U.S. access to the foreign market on comparable terms. In other cases the bills attempt to define unfair trading practices or government policies that work to the detriment of U.S. industries competing with import goods – for example, the issue of natural resource "upstream" subsidies. The focus of these latter bills is on defining "a level playing field" primarily in terms of U.S. standards and practices. This shift in focus to bilateral trade linkages and conditionality represents a break from the tradition of U.S. trade policy since World War II.

> Instead of seeking solutions through enforcement or negotiation of reciprocal agreements, non-discrimination, and, more generally, the rules of the General Agreement on Tariffs and Trade (GATT), the most common congressional approaches are based on unilateral standards of reciprocity, discrimination, and the threat of retaliation. Successive administrations have opposed similar approaches on the

> grounds they violate U.S. international obligations, undermine U.S. global leadership, and are economically counterproductive. (Destler 1986, 76, citing Ahern and Reifman)

The general level of tariff protection has declined in the United States and other industrialized countries as a consequence of multilateral trade negotiations under the General Agreement on Tariffs and Trade (GATT). For example, following the Tokyo Round of multilateral trade negotiations (1974-1979), the level of current U.S. duties has fallen to 21.2 per cent of the 1930 level (Baldwin 1984, Table 1-1). Another indicator of greater liberalization with respect to tariff barriers is the average duty on dutiable imports. The rate of duties collected on dutiable imports has fallen from 53.5 per cent in 1933 to 5.2 per cent in 1982 (U.S. Trade Representative 1984, 187).

Where the real thrust towards greater protection in the United States has occurred is in the realm of "special protection". Hufbauer et al. (1986, 2) define special protection as "exceptional restraints on imports, implemented through high tariffs, quota restraints, or other limitations that go well beyond normal tariff or border restrictions." Included in the category of special protection are exceptionally high tariffs, escape-clause relief (Section 201 of the Trade Act of 1974), presidential use of inherent constitutional powers, statutory framework for discretionary protection, and statutory quotas. The estimated share of U.S. imports covered by special protection increased from 8 per cent in 1975 to 21 per cent in 1984 (Hufbauer et al. 1986, 20).

Table 1.1 provides a set of estimates of the increasing importance of non-tariff barriers among Canada's major trading partners. The non-tariff barriers restricting imports include quantitative restrictions (quotas), administrative and bureaucratic procedures (for example labeling and national standards), contingent-protection measures (countervail and antidumping duties), and voluntary export restraints (Carmichael 1985, 30). Between 1981 and 1983 the United States imposed new import restrictions amounting to 6.5 per cent of total manufactured imports; this increase was greater than the value of restricted imports had been in 1980. The United States showed greater growth in import restrictions over the period 1981-1983 than did either Japan or the European Economic Community (EEC). Further evidence of an increasing reliance by the United States on contingent protection is given in Table 1.2. For the period July 1982-December 1984 the United States had the greatest number of countervailing duties initiated, the largest number of provisional measures adopted, and the largest number of cases where definitive duties were imposed.

Table 1.1
Measures of Import Restrictions for Manufactured Goods, Selected Developed Countries, 1980 and 1981-1983 (percentage of 1980 dollar values)

		Ratio of Restricted Imports to Total Manufactured Imports	Ratio of Comsumption of Restricted Manufactured Goods to Total Consumption of Manufactured Goods
United States	1980	6.20	20.3
	Δ1981-83	6.52 (+)	14.7 (+)
European Economic Community	1980	10.80	23.7
	Δ1981-83	4.08 (+)	4.7 (+)
Japan	1980	7.20	15.7
	Δ1981-83	0 [a]	n.a.

Source: B. Balassa and C. Balassa, "Industrial Protection in Developed Countries," *The World Economy* 7 (June 1984): 187, as cited in Edward A. Carmichael, *Reorienting the Canadian Economy* (Toronto: C.D. Howe Institute, 1985), p. 30.

Notes: Data for 1980 represent restrictions existing in that year. Data for subsequent years represent new restrictions expressed in terms of 1980 dollar values.
n.a. means not available.
a. Japan imposed no new restrictions in the 1981-1983 period.

Table 1.2
Countervailing Duty Actions, July 1982 - December 1984
(number of cases)

Initiating Country	Actions Initiated	Provisional Measures Adopted	Definitive Duties Adopted
United States	103	80	37
European Economic Community	4	1	3
Canada	9	5	2
Australia	16	17	0
Chile	62	1	0
Japan	1	0	0

Source: S.J. Anjaria, N. Kirmani, and A.B. Petersen, *Trade Policy Issues and Developments* (Washington, D.C.: International Monetary Fund, July 1985), pp. 110-11, as cited in Edward A. Carmichael, *Reorienting the Canadian Economy* (Toronto: C.D. Howe Institute, 1985), p. 31.

The shift of the United States towards increased use of non-tariff barriers to trade, especially the application of contingent protection, has had serious implications for Canada. Table 1.3 provides an overview of the range of Canadian exports threatened by U.S. protectionism. Such a table is quickly out of date as new cases are initiated and existing ones disposed of, but it does illustrate the range of industries subject to trade barriers. Three exports – softwood lumber, carbon steel, and Atlantic fish – account for over 80 per cent of the approximately $7 billion in exports listed as threatened.

Canadian exporters have attempted to avoid contingent protection or legislated access to the U.S. market by adopting voluntary export restrictions. For example, Canadian iron and steel exports, worth $2.8 billion in 1985, are currently the focus of U.S. congressional concern (*Globe and Mail* 1987d, 1987e). In 1984 the United States imposed a quota system on iron and steel imports. Canada was exempted on the understanding that its U.S. market share would not exceed 3 per cent. However, recent data show that Canada's share of the U.S. market amounts to 3.8 per cent. In reaction Senator John Heinz (Republican, Pennsylvania) threatened to reintroduce legislation in the 100th Congress that would impose tough quotas on iron and steel imports from Canada. Canada's 13 steel-producing companies have responded by voluntarily attempting to restrain exports to a level that the United States can live with. However, the allocation of implicit quota among the firms and the role of the federal government in agreeing to or even permitting such an agreement is apparently in doubt. This issue is not settled.

The current evidence suggests that contingent protection will become even more central to U.S. trade policy if Congress has its way. The Trade Bill H.R. 3 passed by the House of Representatives in the 100th Congress has already been discussed above. The pressure for increased protection is also evident in the Senate. Lloyd Bentsen (Democrat, Texas), chairman of the Senate Finance Committee in the 100th Congress, and Senator John Danforth (Republican, Missouri) have drafted trade legislation that would further strengthen the focus on reciprocity and retaliation, incorporating it into law (*Globe and Mail* 1987f). Moreover, the provisions of this draft legislation represent a bipartisan consensus. Under the proposed legislation the president would be required to protect a U.S. industry from imports when the International Trade Commission (ITC) agrees unanimously that the industry has been harmed by imports but has the potential to become competitive. Currently, under "escape clause" investigations, the president has discretion whether or not to agree to ITC recommendations. The legislation would also require the president to retaliate if a complaint of unfair foreign trade practices is sustained,

Table 1.3
Canadian Exports Threatened by U.S. Protectionism

Product	Value of Exports to U.S. 1984 (CAN$ millions)	Type of U.S. Trade Action	Date of Action or Petition to International Trade Commission	Status in late 1986
Softwood lumber	3,271	Legislative attempts to reduce imports from Canada	Fall 1985 (1982 at I.T.C.)	Preliminary Injury Ruling July, 1986,Provisional Duty of 15%, Dec. 30, 1986 agreement led to termination of proceedings in return for 15% export tax imposed by Canadian government
Carbon steel	1,329	Voluntary export restraint (VER) agreements with thirteen countries	1985	Imports from Canada currently under surveillance
Atlantic fish - fresh ground fish	754	Countervail investigations	Aug. 1985	Preliminary injury ruling, Sept. 1985; provisional duty of 6.8%, Jan. 1986; final duty of 5.82% Mar. 1986
Hogs and pork	404-517	Countervail investigations	Nov. 1984	Duty of 4.39% on hogs, July 1985. No duty on pork
Iron and steel Pipes and tubes	331	a) Country-of-origin marking requirement introduced b) Antidumping and countervail investigations	1985	Canada adopted identical requirements, July 1985; U.S. investigations still under way

Table 1.3 (continued)

Product	Value of Exports to U.S. 1984 (CAN$ millions)	Type of U.S. Trade Action	Date of Action or Petition to International Trade Commission	Status in late 1986
Softwood shingles and shakes	260	Escape clause investigation	1985	ITC ruled injury, Feb. 1986; final duty, May 1986 – 35% for 2 1/2 years, 20% for next 2 years, and 8% for final 6 months
Sugar and products containing sugar	164	Quotas imposed to protect U.S. price support system	1984/85	Coverage narrow but quotas remain in effect until Sept. 30, 1986
Rock salt	29	Antidumping investigation	1985	No injury found, early 1986
Dried salt codfish	20-30	Antidumping investigation	July 1984	Duties of 16.3% and 20.75%
Raspberries	6-9	Antidumping and countervail investigations	Dec. 1984	Duty of 0.99%, revoked Jan. 1986
Manhole covers, sewer grates, and construction castings		Antidumping	1985	Duty of 10.2%, Feb. 1986
Specialty steel products	n.a.	Quotas imposed	1983	Quotas imposed in 1983 remain in effect until 1988
Eggplants	n.a.	Antidumping investigation	1983/84	No injury found in final ruling; appeal in

Source: Adapted from Table 1 of Alan M. Rugman, "U.S. Protectionism and Canadian Trade Policy," *Journal of World Trade Law* 20, no. 4 (1986): 311, as cited in Edward A. Carmichael, *Reorienting the Canadian Economy* (Toronto: C.D. Howe Institute, 1985), Table 7.

and investigation of such complaints would have to be completed within 18 months. This legislation would strengthen the already formidable array of contingent-protection measures incorporated in U.S. trade law. It would also further reduce executive discretion in administering trade policy by giving greater force to the findings of quasi-judicial bodies such as the ITC.

The proposed legislation sponsored by Bentsen and Danforth still provides for multilateral trade negotiations under GATT; negotiations would continue for 10 years after the current enabling legislation expires in January 1988. However, the president would be required to submit to Congress for approval a detailed policy statement on the substance of proposed GATT negotiations.

A number of competing explanations have been offered for the dramatic rise in contingent protection by the United States. In the context of the Softwood Lumber dispute it was argued that the political pressures associated with the dispute were really a reflection of mid-term elections to the U.S. Congress. Thus the protectionist pressures affecting other Canadian export industries were expected to subside with the November 1986 elections. There are a number of shortcomings with this perspective. The most obvious is that the rise in protectionist sentiment and the resorting to contingent or special protection date from the early 1980s, as Table 1.2 suggests. Moreover, the proposed trade legislation of Senators Bentsen and Danforth certainly seems to continue the trend of strengthening contingent-protection provisions in trade legislation.

The consequences of a high-valued dollar – massive trade deficit and a squeeze on U.S. exports – are another widely cited cause of the surge in protectionist sentiment since the 1980s. The U.S. trade deficit reached a record of $169.8 billion (US$) in 1986 from its previous high of $148.5 billion. The increasing import penetration induced by the appreciation of the U.S. dollar has had an adverse impact on import-competing industries in the United States. Employment and investment have fallen significantly in a range of traditional "smoke-stack" industries, such as steel.

As will be shown in Chapter 2, congressional efforts to legislate improved U.S. trade performance are well off the mark. A main contributor to the U.S. trade problem is the large government deficit and its effect on the U.S. dollar. Congressional trade initiatives appear directed far more to forcing its major trading partners to accommodate U.S. fiscal policy than to enhancing trade liberalization.

The shift of the United States to a less open trading regime has been linked to a relative decline in its economic power, especially since 1960. Of the 15 largest industrial countries, the U.S. share of merchandise exports was 25.2 per cent in 1960, 20.5 per cent in 1970, and 18.3 per cent in 1979. The U.S. share of the total Gross National

Product (GNP) of these countries fell from 57.1 per cent in 1960 to 50.2 per cent in 1970, and to 38.1 in 1979 (Baldwin 1984, 22). Baldwin (1984, 22-24) notes that the decline in relative economic importance of the United States has probably led it to stress the economic benefits of trade to its economy and to move away from pursuing trade liberalization primarily for the purpose of strengthening U.S. security and national interests. This shift to a much greater emphasis on the commercial benefits of trade has likely contributed to an increase in the number of bilateral and multilateral trade disputes as bargaining over the gains from trade has assumed greater importance. To the extent this explanation is correct, it suggests that trade disputes involving the United States and its major trading partners will become even more numerous in light of the continued economic growth of Japan and the EEC. Unfortunately, Canada is often caught in the middle of congressional trade initiatives aimed at other countries, such as Japan.

A further indicator of Congress asserting its paramountcy in trade issues, a function entrusted to it under the U.S.Constitution, is the nature of its relationship to quasi-judicial trade bodies such as the ITC and ITA, a branch of the U.S. Department of Commerce. The popular perception, even within Canada, that these bodies are arm's-length from political pressure – or at least from Congress's view of trade policy – is simply not correct. For example, Baldwin (1985, 100) cites Senator Russell Long, chairman of the Senate Finance Committee, arguing in the 1960s that "it is to Congress, not the Executive, that the Tariff Commission [the forerunner of the International Trade Commission] is expected to be responsive."

In the case of the ITC, Congress has two mechanisms for keeping it under rein – funding and confirmation of presidential nominees to the commission's board – and both have been exploited. The issue of funding for the ITC was addressed by the Trade Act of 1974. Control over the commission's budget was removed from the executive branch and became the responsibility of Congress. Congress has been able to influence the composition of the ITC board and hence the perspective of the commission through the right of the Senate Finance Committee to approve presidential nominees. Baldwin (1985, 100), for example, notes that many nominees asserted during the confirmation hearings that they perceived the commission "as a fact finding arm of Congress."

The more active role of Congress in trade issues, as well as its interest in making the ITC more responsive to congressional concerns, is reflected in changes in the employment experience of ITS commissioners. Between 1953 and 1967, 7 of the 13 ITC appointees either had experience of the executive branch or had been members of the Commission staff, 3 were academics, 2 were from the private

sector, and 1 had been in Congress. The employment background of ITC appointees for 1968 to 1983 was virtually the reverse of this: of the 16 appointees, 8 had congressional experience, 7 were from the private sector, and 1 was from the executive branch (Baldwin 1985, 76).

The argument is not that Congress directly pressures the ITC on particular disputes or issues. Rather the claim is that the ITC will generally reflect Congress's views on trade issues to a much greater extent than, say, the views of the Executive. Thus, in a period of protectionist sentiment it is unlikely that the ITC will be far out of step with the broad concerns of Congress on trade issues. Moreover, the efforts of Congress to reduce further the discretionary authority of the Executive with regard to a range of ITC recommendations is additional evidence that Congress finds the ITC generally favourable to its perspective on trade issues.

The ITA is also not immune from political pressure from Congress, although this pressure is of a more indirect nature. The Trade Agreement Act of 1979 moved the administration of antidumping and countervailing-duty laws from Treasury to Commerce because many members of Congress felt that Commerce would be more sympathetic to their views. (Baldwin 1985, 118). The subtle but effective mechanism by which Congress influences the ITA is its ability to pass legislation that would make life in the realm of international trade politics difficult for Commerce and the Executive. This issue is discussed in Chapter 2 with respect to congressional bills dealing with resource input subsidies. Passage of a countervailing bill would provoke symmetrical legislation from major trading partners and possibly subject billions of dollars of U.S. agricultural exports to countervailing duties.

The effort of Congress to incorporate reciprocity and retaliation provisions into proposed trade legislation places great stress on the ITA to accommodate congressional trade concerns. If the ITA constantly invokes "narrow" definitions of legislative requirements – the issue of "specificity" or "general availability," for example – the temptation is for Congress to legislate directly what it requires rather than to permit some flexibility in interpretation on the part of the ITA. The result of such pressures is that the ITA notion of countervailable subsidy is becoming increasingly nebulous, as Steger (1986, 96) notes:

> The composite definition of countervailable subsidy, gleaned from administrative determinations, judicial interpretations, and Congressional amendments, tells foreign governments what the U.S. considers to be an unfair government practice. Unfortunately, the U.S.

> definition has become so broad in recent years that virtually no government policy – with the probable exception of universally available tax advantages or social benefits – is immune from potential attack.

One point that should be emphasized is that the U.S. system of countervail legislation has been developed and operated more or less in conformity with GATT Articles VI and XVI and with the Supplementary Subsidies Code, which in turn are largely an extension internationally of U.S. law and practice. Whatever the problems of these GATT rules, they have been agreed to by the Canadian government. Moreover, Canada has itself adopted a countervailing system, which largely parallels the U.S. system. The basic purpose of both systems is the same – to give additional protection to domestic producers against international competition.

What are we trying to highlight in this study is the essentially political nature of the application of contingent-protection laws. Although U.S. trade tribunals have impressive titles – International Trade Commission, International Trade Administration – they are not immune from domestic political considerations. Equally, Canadian bodies dealing with trade issues are subject to similar pressures. At least in the case of the United States the policies are open and subject to public scrutiny and discussion.

A Case Study: Softwood Lumber in British Columbia

Softwood lumber exports from British Columbia represent an ideal case study of the issues involved in trade disputes in the resource sector. Softwood lumber exports from Canada, primarily from British Columbia, accounted for 32 per cent of the U.S. market in 1986. Domestic producers in the United States have claimed for years that pricing policies for Crown timber and the range of regional development policies have provided subsidies in the Canadian industry, especially in British Columbia.

Lumber producers in the United States, in addition to their use of existing trade remedies, have moved increasingly to the political arena for support in their efforts to restrict imports. Efforts have been made to change the definition of subsidy used by the U.S. Department of Commerce in its determination of unfair trading practices under current trade legislation. H.R. 3, introduced in the 100th Congress and referred to earlier, is perhaps the best current example of such legislation. Compared with the present, very broadly interpreted definition of subsidy, such bills, if enacted, would give lumber producers an even more powerful tool with which to seek the

imposition of countervailing duties on Canadian softwood lumber exports to the United States.

In May 1983 the issue of countervailing tariffs on Canadian softwood lumber imports into the United States appeared to have been resolved once and for all. The ITA found that Canada's practices regarding the pricing and allocation of the timber harvest did not constitute a countervailable subsidy to the softwood lumber industry. A number of subsidies were found to exist from a wide range of federal and provincial government programs, but they were all below the threshold (*de minimis*) level. In its 1983 determination, the ITA was very clear in explaining precisely why Canadian timber was not subject to countervailing duties under existing U.S. law. Then the U.S. Coalition for Fair Lumber Imports filed a petition before the ITC on May 19, 1986, requesting a 27 per cent duty be imposed on Canadian softwood lumber imports. The evidence provided by the coalition differed little in substance from that offered in the 1982 phase of the dispute. Yet on October 16, 1986, the ITA revised its previous decision and found that Canadian stumpage values were too low and did constitute a countervailable subsidy. In its preliminary determination, the ITA estimated the net subsidy to be 15 per cent *ad valorem*.

The final determination by the U.S. Department of Commerce was due December 30, 1986. However, Canada and the United States at the last minute reached an agreement which led the U.S. Coalition for Fair Lumber Imports to withdraw its petition from the Department of Commerce and therefore led to the termination of countervail proceedings. The Canadian government agreed to impose a 15 per cent *ad valorem* duty on softwood lumber exports. Under the agreement the tax on exports is to be replaced by increases in provincial royalties and in stumpage charges that have a value equivalent to the revenues raised by the export tax. This agreement is historic and has enormous implications for the Canadian forest products industry in particular, and Canadian resource industries in general, as we argue later.

Many of those involved in the 1986 phase of the Softwood Lumber dispute assumed with some justification that, since neither the law nor the material facts had changed since 1983, the same successful result could therefore be predicted. What had changed in the interim, however, was the economic and political environment in which U.S. trade laws are applied. It was these factors that led the U.S. Department of Commerce to change its position and resulted in its finding that Canadian stumpage was too low and constituted countervailable domestic subsidies. A higher priced U.S. dollar, low productivity growth (except in the Pacific Northwest), and a combination of timber-supply and management constraints made the

U.S. softwood lumber industry especially vulnerable to competition from imports. The response of the U.S. industry and their political allies was to ignore the role of freely operating market forces and comparative advantages and instead to argue successfully that the industry's problems stemmed from the consequences of subsidized stumpage available to Canadian producers.

The Structure of the Study

This study of the Softwood Lumber dispute consists of five chapters following this Introduction. The study begins with the next chapter, the second, which assesses the available evidence regarding the relative importance of two sets of factors – relative cost levels and resource endowments, and explicit and implicit subsidies to softwood lumber producers – in explaining the current pattern of trade in softwood lumber between Canada and the United States. It provides an overview of the current pattern of trade in lumber and paper products between Canada and the United States, with particular emphasis on softwood lumber exports from British Columbia. The remainder of the chapter provides a detailed analysis of the roles of market forces and stumpage values in determining the level of, and growth in, the market share of Canadian softwood lumber producers in the United States.

The third chapter analyses the economic logic found in the ITA determinations of 1983 and 1986 in the Softwood Lumber dispute.

The fourth chapter reviews existing and proposed U.S. trade legislation relevant to the softwood lumber dispute. The focus of this chapter is on explaining how and why the interpretation of countervailable subsidy has changed since 1983 even though the relevant legislation may not have changed.

The fifth chapter examines the political economy of protectionism in the Softwood Lumber dispute. The theme here is the use of U.S. trade law by domestic producers to achieve protection and to redistribute income to the U.S. industry at the expense of U.S. consumers and Canadian producers. This section is relatively pessimistic with regard to the possibility of continued unhindered access of Canadian resource exports to the U.S. market. An analysis of the distribution of costs and benefits associated with protection in the Softwood Lumber case suggests that the economic pay-off to the U.S. industry is very high, although the distribution of these "benefits" within the industry will come as a surprise to many. The chapter concludes with a review of the Memorandum of Understanding settling the 1986 phase of the Softwood Lumber dispute and review of the competing options available to the Canadian negotiators. Here the focus is on the trade-offs between, on the one

hand, pragmatism and the desire to keep resource revenues in Canada rather than have them go as import duties to the U.S. Treasury and, on the other hand, issues of national sovereignty over resource pricing, as well as the implications of any precedent set for other Canadian resource industries.

The final chapter attempts to draw some lessons from the Softwood Lumber dispute for future trade negotiations between Canada and the United States.

Throughout the text the term *stumpage* is meant to refer to the value of standing timber. Unfortunately, both the ITA and ITC use the term in a broader sense to mean both timber *and* its value. Since it is difficult to highlight this distinction each time material from the ITA and ITC is cited, the reader is warned of this problem at the outset.

Notes

1. Softwood lumber exports to the United States amounted to $3.3 billion in 1984 or 4.0 per cent of total domestic exports destined for the United States (Statistics Canada 1984, Table 3).

2. Anderson (1987, pp. 38-40) and Matas (*Globe and Mail* 1987a) discuss the protectionist pressures facing Canadian uranium exports to the United States.

3. Anderson (1987, 35) notes that U.S. potash production and employment have declined by 50 per cent and 67 per cent, respectively, since 1980.

4. In 1984 the Potash Corporation of Saskatchewan accounted for 35 per cent of the province's production (Olewiler 1986, 40).

Chapter 2:

The Economic Background to the Softwood Lumber Dispute

The basic allegation made by the U.S. Coalition for Fair Lumber Imports in its petition filed with the ITC on May 19, 1986, was that Canadian timber harvested from Crown lands is priced so low that it amounts to a subsidy to the Canadian softwood lumber industry. The coalition requested that a 27 per cent duty be imposed on softwood lumber imports from Canada. The complete process leading to a final decision to impose a countervailing duty is complex, and a detailed examination of the legal context is made in Chapter 4. The purpose of this chapter is to discuss each step in the countervailing-duty investigation into the softwood lumber industry, since the investigation involved a number of important economic decisions regarding the pricing of Canadian timber, the determinants of Canadian softwood lumber exports to the United States, and the impact of these exports on the U.S. industry. A brief outline of the legal process will be used as the context for this discussion of economic issues.

The Countervail Process

A countervailing duty can be imposed only if the International Trade Administration (ITA) determines that an imported good is being subsidized *and* the International Trade Commission (ITC) finds that imports of the good in question are hurting the competing U.S. industry. On June 26, 1986, the ITC found "that there is a reasonable indication that the domestic industry producing softwood lumber is

materially injured by reason of allegedly subsidized imports from Canada" (U.S. International Trade Commission 1986, 15). The case then proceeded to the ITA which, in its preliminary determination of October 16, 1986, found that "the pricing practices of Alberta, British Columbia, Ontario, and Quebec for harvesting softwood timber ('stumpage') constitute subsidies because they are provided at preferential prices to a specific industry or group of industries" (U.S. Dept. of Commerce 1986, 1). On December 30, 1986, the ITA was to render its final decision on the question of subsidies. Had this decision affirmed the preliminary finding of countervailable subsidy the case would then have gone back to the ITC for a final injury determination. The ITC would have had to have released its final decision within 45 days of the ITA's final determination. The agreement between the Canadian and U.S. governments on December 30, 1986, led to the termination of the countervail process.

The economic issues involved in each stage of the countervail process are complex. Yet there are several factors that virtually preclude any reasonable level of analysis of the economic issues at stake. The first is the tight schedule imposed under U.S. law for each stage of the process. From the date of filing of a petition by an interest group, such as the U.S. Coalition for Fair Lumber Imports, the entire process can take no longer than 270 days. Each step in the process as the case moves back and forth between the ITC and the ITA has a specific time limit.[1]

The second major problem is that the onus is on the respondent(s) in the countervailing proceedings to provide evidence refuting the allegation of the petitioner. It is far less expensive for petitioners in such a case to allege injury from subsidized imports than it is for the respondents to prove that there is none. If the respondents fail to present evidence supporting their position, the ITC will decide the matter on the basis of the best evidence it has available, which may very well be evidence submitted by the petitioners. The statutory time frame in the process further exacerbates the problem of bringing together the detailed data so often required.

An added, but important, complication in the process is that it is only the foreign industry's cost structure that is under review. Subsidies, tax relief, and other benefits provided to the U.S. industry in question are not relevant to the investigation. Thus, the claim that subsidies to the foreign industry are merely sufficient to offset subsidies available to the U.S. industry is not a defence in countervail proceedings. That is, the "level" playing field is not a relevant concept in countervail investigations as currently legislated.

Finally, there is the intangible but very real problem presented by the fact that political rather than economic factors may dominate the quasi-judicial proceedings. This issue is discussed in greater

detail in Chapter 5. Yet one spectre looming over the countervail process in softwood lumber should be borne in mind from the start. The U.S. Congress has threatened to pass legislation specifically aimed at resource input subsidies provided to foreign resource processors through allegedly "underpriced" raw material inputs. This threat must be of great concern to the U.S. Department of Commerce, which administers the ITA. Such legislation, if passed, might violate U.S. obligations under GATT and would certainly provoke retaliatory legislation by U.S. trading partners. Billions of dollars of U.S. agricultural and primary manufactured exports could be subject to similar countervail levies in response to such legislation.[2] The Department of Commerce might very easily find itself moving from the arena of managed trade to the problem of containing a full-scale trade war. Canadian softwood lumber exports were seen by many influential congressmen and senators to epitomize the "unfair" competition faced by many U.S. resource-processing industries. In its preliminary decision that a countervailable subsidy existed in the Canadian softwood lumber industry, the ITA imposed an *ad valorem* duty of 15 per cent. The possibility that this was a gesture to protectionist sentiments in Congress should not be dismissed.[3] It is perhaps the only plausible explanation for the weak level of economic analysis and the contrived reasoning found in the preliminary determination. However, the analysis of the determination is left for the next chapter.

The Key Issue – Market Forces or Subsidy?

The imposition of countervailing duties requires evidence that the domestic industry in the United States has been *injured* by imports of a *subsidized* good. Addressing the issues of injury and subsidy in the Softwood Lumber dispute is equivalent in economic terms to examining the determinants of the share of the U.S. market accounted for by Canadian softwood lumber. Between 1982 and 1985 the Canadian share of U.S. softwood lumber consumption rose from 27.6 per cent to 31.6 per cent. The basic question is whether market forces unrelated to Canadian stumpage policies were responsible for this increase or whether access to underpriced timber was the critical factor (U.S. ITC 1986, A-12). The discussion of the importance of market forces focuses on two areas – exchange rates and productivity. The issue of subsidy requires a detailed examination of the economic issues involved, from the perspective of U.S. countervail legislation, and a review of management policies in British Columbia and their link to production decisions by the province's softwood lumber industry.

British Columbia and the Forest Products Industry

Although the U.S. Coalition for Fair Lumber Imports has alleged stumpage prices are too low in Quebec, Ontario, Alberta, and British Columbia, it is British Columbia's softwood lumber industry and Crown pricing policies that are at the heart of the dispute. It is easy to see why this is so since the province dominates the Canadian softwood lumber trade. British Columbia accounted for 57 per cent of Canada's total 1985 exports of softwood lumber to the United States, or 18 per cent of U.S. consumption. But British Columbia's current share of Canadian softwood lumber exports has actually declined from its 1983 level of 61 per cent (U.S. ITC 1986, A-35).

British Columbia would have been by far the biggest loser among the provinces if countervailing duties had been imposed on Canadian softwood lumber exports to the United States. It still remains the biggest loser under the agreement that was reached, although the cost is reduced significantly because the province receives the export tax revenues. The extent of the impact stems from both the concentration of the province's lumber exports, which are largely to the U.S. market, and the importance of the industry in the provincial economy. Table 2.1 shows the distribution of British Columbia's softwood lumber exports. The United States is the single largest market for the province's softwood lumber exports and, since 1983, has accounted for at least 56 per cent of all shipments. Efforts to diversify the province's export markets for lumber have been hampered by transportation costs to other markets, by tariff and non-tariff barriers (for example, building codes) imposed by potential importers, and by the desire of some countries to import logs rather than lumber.

The forest products industries are the single most important group of industries in the British Columbia economy. Furthermore, the extensive economic linkages between the wood products and the paper and allied products industries mean that factors reducing profitability in one industry can have similar adverse effects on the others. Thus, their collective contribution to the provincial economy must be considered. Two examples illustrate the nature of these linkages. Wood chips produced by the wood products industry are an increasingly important input to the pulp and paper industry.[4] A fall in lumber production would reduce chips production and deprive the pulp and paper industry of an important source of fibre supply. Harvesting decisions are the second case in point. Many timber stands, especially in the Coast region, contain a variety of species of varying quality and are economic to harvest only if timber can be allocated to both the wood products and the pulp and paper industries during harvesting. A reduction in demand for sawlogs might lead, then, to a fall in supply of both sawlogs and pulp logs.

Table 2.1
Destination of British Columbia Lumber Shipments, 1976-1985
(in billions of board feet and as percentage of total B.C. lumber shipments)

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Canada	2.7	2.6	2.7	2.8	3.1	3.4	2.9	3.5	3.8	4.4
	25.5%	21.0%	21.1%	22.0%	26.1%	31.5%	27.9%	27.3%	28.1%	30.1%
United States	6.2	8.0	8.4	7.7	6.3	5.3	5.2	7.2	7.6	8.2
	58.5%	64.5%	65.6%	60.6%	52.9%	49.1%	50.0%	56.3%	56.3%	56.2%
European Economic Community	.8	.8	.7	.9	1.0	.8	.8	.6	.6	.5
	7.5%	6.5%	5.5%	7.2%	8.4%	7.4%	7.7%	4.7%	4.5%	3.4%
Other	.9	1.0	1.0	1.3	1.5	1.3	1.5	1.5	1.5	1.5
	8.5%	8.0%	7.8%	10.2%	12.6%	12.0%	14.4%	11.7%	11.1%	10.3%
Total Shipments	10.6	12.4	12.8	12.7	11.9	10.8	10.4	12.8	13.5	14.6

Source: "British Columbia Forest Industry Statistical Tables," Council of Forest Industries of British Columbia, April 1986.

Finally, it is most likely that a positive countervail decision on softwood lumber would be followed by a similar duty on pulp and paper exports to the United States. The U.S. Coalition for Fair Lumber Imports has alleged that timber is priced too low and these low stumpage values constitute a subsidy to industries such as softwood lumber. Obviously the pulp and paper industry is open to a similar countervail investigation as it too uses timber from Crown lands as an input. The December 30, 1986, agreement provides no protection to the pulp and paper industry against countervail proceedings similar to those launched against softwood lumber and, in fact, would seem to set the stage for such a petition.

Table 2.2 demonstrates the importance of the forest products industries to British Columbia and to Canada. It is evident that these industries are of much greater relative importance to British Columbia than to the country as a whole. The wood products and the paper and allied products industries, between them, accounted for 12.9 per cent and 14.4 per cent of Canadian manufacturing employment and wages and salaries, respectively, in 1983. In British Columbia, the two industries contributed 43.4 per cent of employment and 48.5 per cent of all salaries and wages in manufacturing. In terms of value added, the forest products industries contributed 12.1 per cent of the Canadian manufacturing total and 43.8 per cent of the British Columbia total. These estimates are indicative of direct contribution alone and omit all the induced income and employment effects in other industries providing goods and services to the forest products industries.

Table 2.3 gives a similar indication of the predominance of British Columbia in Canada's logging industry. Whether measured in terms of number of employees, salaries and wages, or value added, British Columbia accounted for approximately half the logging industry activity in Canada in 1983.

The U.S. Economy

The Softwood Lumber dispute cannot be examined without some understanding of the broad forces operating in the U.S. economy. The performance of the U.S. economy in the 1980s has been mixed. On the positive side, consumer price increases have dropped from an annual rate of 13.5 per cent in 1980 to 3.5 per cent in 1985 (IMF 1986, 188). Yet the evidence for unemployment is less positive. In 1980 and 1985 the rate of unemployment was at 7.2 per cent but it reached rates as high as 9.7 per cent in 1982 (IMF 1986, 183). The growth of real GNP achieved by the U.S. economy in the 1980s has also been mixed relative to the performance of other countries. In 1980 and 1982 real output actually declined, while in 1983 and 1984 real growth rates of

Table 2.2
Forest Products and Manufacturing Activity, Canada and British Columbia, 1983
(percent of total manufacturing in parentheses)

	Total Employees (thousands)	Salaries and Wages ($ billions)	Value Added ($ billions)
Canada			
Total - All Manufacturing	1,670	39.6	81.8
Wood Products Industries	102 (6.1%)	2.4 (6.1%)	4.0 (4.9%)
Paper and Allied Products Industries	114 (6.8%)	3.3 (8.3%)	5.9 (7.2%)
British Columbia			
Total - All Manufacturing	133	3.9	6.9
Wood Products Industries	40 (30.3%)	1.3 (32.4%)	1.9 (27.6%)
Paper and Allied Products Industries	17 (13.1%)	.6 (16.1%)	1.1 (16.2%)

Source: *Manufacturing Industries of Canada, 1983* Statistics Canada 31-203 (April 1986).

Table 2.3
Logging Industry Activity, Canada and British Columbia, 1983

	Total Employees (thousands)	Salaries and Wages ($ billions)	Value-Added ($ billions)
Canada	46	1.2	2.2
British Columbia	20	.6	1.2

Source: *Selected Forestry Statistics Canada 1985*, Canadian Forestry Service Information Report E-X-37.

3.5 and 6.5 per cent, respectively, were well above rates achieved in other industrial economies (IMF 1986, 180).

Government Budget Deficits and Trade Deficits

For many observers, the outstanding feature of the U.S. economy since 1980 has been the sharp rise in the federal government deficit shown in Table 2.4, column 1. The rapid growth of the deficit reflects the failure of President Reagan and Congress to restrain federal government expenditures and the consequences of maintaining existing tax rates or, in some cases, reducing them, despite the size of the deficit. The tax policy was motivated by the belief that lower taxes would stimulate investment and employment and lead to higher levels of economic activity which, in turn, would result in higher tax revenues than before. The evidence suggests that these expectations were not realized.

Net federal borrowing rose in lock-step with the deficit (Table 2.4, column 2) and exerted upward pressure on interest rates as investors had to be induced to hold government bonds instead of private debt offerings. Despite higher returns to saving, the domestic volume of savings in the United States was not sufficient to finance both federal borrowing requirements and other private-sector investment opportunities. Consequently, foreign savers responded to the incentives to invest in the U.S. economy, where returns were higher than those prevailing elsewhere.

The influx of capital into U.S. money markets placed significant upward pressure on the U.S. dollar relative to other currencies. The appreciation of the dollar made U.S. exports more expensive abroad and, at the same time, reduced the U.S. price of imports in the U.S. market. The effect on the U.S. merchandise trade balance is quite evident from column 3 of Table 2.4. The merchandise trade deficit almost doubled between 1983 and 1985.

Exchange Rates

Figure 2.1 illustrates the extent of the appreciation of the U.S. dollar relative to all currencies and relative to the Canadian dollar over the period 1982-1985. The U.S. dollar's effective exchange rate summarizes the U.S. dollar's performance against other currencies. It is calculated as a weighted sum of bilateral exchange rates for the dollar, using weights that reflect the pattern of U.S. trade. The Canadian dollar effective exchange rate is calculated in a similar fashion. The U.S. dollar exchange rate for Canada is simply the amount of U.S. currency required to purchase a Canadian dollar.

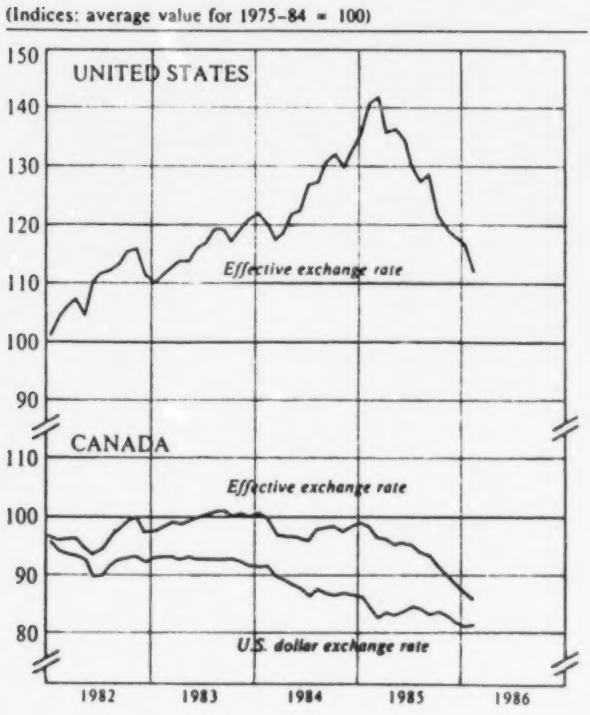
Table 2.4
U.S. Budget and Merchandise Trade Balances, 1974-1986
(billions of US$)

Year	Federal Government Budget Surplus (+) or Deficit (-) (1)	Net Federal Borrowing (2)	Merchandise Trade Surplus (+) or Deficit (-) (3)
1974	-4.48	2.03	-5.51
1975	-53.93	53.09	+8.91
1976	-74.86	82.79	-9.49
1977	-52.23	55.83	-31.10
1978	-58.94	61.99	-33.95
1979	-35.95	39.82	-27.54
1980	-76.18	76.61	-25.50
1981	-78.74	84.40	-27.97
1982	-125.69	138.76	-36.50
1983	-202.52	215.59	-67.26
1984	-178.26	174.08	-112.51
1985	n.a.	n.a.	-124.45
1985-I	-55.68 [a]	n.a.	-23.46
1985-II	-27.45 [a]	n.a.	-30.35
1985-III	-47.26 [a]	n.a.	-33.65
1985-IV	-76.68 [a]	n.a.	-36.98
1986-I	n.a.	n.a.	-34.56
1986-II	n.a.	n.a.	-36.29

Source: *International Financial Statistics Yearbook 1986* (Washington, D.C.: International Monetary Fund, 1986), pp. 668-91.

Notes: *n.a.* means not available
a. Budget Year End September 30.

Figure 2.1
Effective Exchange Rates,
United States and Canada, 1982-1985



Source: *World Economic Outlook April 1986* (Washington, D.C.: International Monetary Fund, 1986), Chart 11, p. 36.

The U.S. dollar appreciated by over 40 per cent between the first quarters of 1982 and 1985 relative to a 1975-1984 base. Obviously, such a sharp rise in the value of the U.S. dollar would reduce the foreign demand for U.S. exports and improve the competitive position of imports in the U.S. market. Over the same period the Canadian dollar did depreciate, but the fall was not comparable to the rise of the U.S. exchange rate. Throughout this period Canada was, in theory, on a flexible exchange rate regime where market forces were to be the main determinant of the value of the Canadian dollar. In fact, however, the variability of the Canadian dollar was managed, and one of the goals of Canadian monetary policy was to maintain some target exchange rate, or at least to prevent too rapid a fall in the value of the Canadian dollar. Although the Canadian dollar did fall relative to the U.S. dollar, it rose relative to many other currencies, such as the Scandinavian. Hence, the effective Canadian exchange rate fell considerably less than the nominal U.S. dollar exchange rate. The net effect of these exchange rate movements was to improve the competitive position of Canadian exports in the U.S. market somewhat but not to the same degree as experienced by other countries.

Import Penetration

The impact of these exchange rate movements on trade volumes is shown in Table 2.5. The volume of U.S. exports declined in three of the four years from 1982 to 1985 whereas import volumes increased significantly, especially in 1983 and 1984. These changes are consistent with the effects of the exchange rate movements just detailed. The fall in import volumes in 1982 for both Canada and the United States reflects the severity of the 1982 economic downturn. Canadian export volumes rose rapidly from 1983 through to 1985, reflecting an increasing volume of trade with the United States, again likely brought about by the observed movements in exchange rates.

Table 2.6 provides some evidence of the degree of import penetration by industry over the period during which the U.S. dollar appreciated. These industries are not necessarily representative – they are those that either have been successful in obtaining protection (Panel A) or are viewed by Congress as facing unfair import competition because of foreign pricing policies for natural resources (Panel B). The Hufbauer et al. (1986) estimates in Panel A are for a sample of industries that have already obtained one or another form of special protection available under U.S. trade remedies.[5] What is particularly worth noting is the diversity of the industries included in the sample, which contains consumer and producer durable goods industries as well as final consumer goods, from orange juice to

Table 2.5
Trade Volumes, Canada and the United States, 1968-1986
(annual changes in per cent)

	1968-71	1978	1979	1980	1981	1982	1983	1984	1985	1986
EXPORT VOLUMES										
Canada	7.1	10.2	1.5	.5	3.6	-0.7	8.8	22.2	4.2	4.2
United States	6.6	10.6	13.8	9.9	-2.5	-11.2	-5.2	5.7	-1.2	3.3
IMPORT VOLUMES										
Canada	7.3	4.2	9.0	-5.3	2.7	-15.3	14.1	18.4	8.2	2.0
United States	7.3	11.9	2.5	-1.5	5.7	-0.3	14.6	28.7	6.5	4.1

Source: *World Economic Outlook April 1986* (Washington, D.C.: International Monetary Fund, 1986), Table A22, p. 202.

Table 2.6
Market Share of Imports by Selected Industries
United States, Various Years
(percentage of apparent consumption by volume)

Panel A	1980	1983	1984
Book Manufacturing	10.6	-	19.5
Benzenoid Chemicals[a]	1.1	-	1.6
Household Glassware	16.2	-	21.6
Rubber Footwear	57.6	-	62.4
Ceramic Table and Kitchen Articles	62.6	-	66.0
Ceramic Floor and Wall Tiles	46.9	-	57.9
Frozen Concentrated Orange Juice	8.1	29.5	-
Canned Tuna	9.6	17.9	-
Textiles and Apparel (Multi-Fibre Agreement III)	12.1	-	20.4
Carbon and Alloy Steel Products Phase III	16.4	-	26.7
Specialty Steel	14.4	-	16.8
Non-rubber Footwear	49.4	-	71.5
Color Television Receivers	11.9	-	34.2
C.B. Radio Transceivers[b]	26.0	-	96.8
Automobiles (Japanese)[c]	34.7	-	34.2
Heavy Weight Motorcycles[d]	60.0	-	31.0

Panel B	1980	1984
Petroleum Products	6.0	9.0
Ammonia	12.8	17.9
Carbon Black	1.0	5.4
Cement	6.5	9.6
Float Glass	2.2	2.4
Lime	2.0	2.0
Metals	23.6	29.6
Methanol	3.4	12.4

Sources: (Panel A) Gary Clyde Hufbauer, Diane T. Berliner, and Kimberly Ann Elliot, *Trade Protection in the United States: 31 Case Studies*, (Washington, D.C.: Institute for International Economics, 1986).

(Panel B) *Potential Effects of Foreign Governments' Policies of Pricing Natural Resources*, U.S. ITC Publication 1696, May 1985 (Washington, D.C.: U.S. International Trade Commission, 1985).

Notes: Dash (-) means not available.

a. Protection undergoing reduction.
b. Special relief expired 1981.
c. Voluntary export restraints began 1981.
d. Restraints imposed 1983.

glassware. Another interesting aspect of these estimates is that in a number of cases protection, regardless of the manner in which it was afforded, was not sufficient to prevent increasing import penetration between 1980 and 1984.

The ITC in 1985 undertook an investigation into the potential effects of foreign governments' policies of pricing natural resources (U.S. ITC, 1985). The investigation was undertaken at the request of Sam Gibbons, chairman of the House Subcommittee on Trade, Committee on Ways and Means, and a sponsor of the trade legislation specifically targeted at "upstream" subsidies received by foreign exporters of processed resource products. The study focused on those countries where information suggested that natural gas, crude petroleum and petroleum products, or metal ores from the public domain were priced to industrial users below export sale prices or world price levels. Softwood lumber was not included in the study, presumably because of the earlier ITC investigation and the fact that there was little evidence of the two-tier pricing policies common in energy. Some of the estimates of import shares are provided in Table 2.6, Panel B. Over the period 1980-1984, there were increases in the U.S. market share of imports for a number of industries which process natural resources or are energy intensive in the processing phase. However, this is not necessarily evidence of the effects of foreign pricing policies. The observed shifts in market share are equally consistent with movements in exchange rates over the period in question. The importance of exchange rate movement was not addressed in the investigation.

Exchange Rates and Canadian Softwood Lumber Exports

The link between exchange rates and the Canadian market share of U.S. softwood lumber consumption is clearly illustrated in Figure 2.2, which is a graph of the data in Table 2.7. Figure 2.2 plots Canadian market share, the U.S. dollar in Canadian dollars, and "real effective exchange rates" against time. Movements in the nominal exchange rate (the U.S. dollar in terms of Canadian dollars) may not reflect one-for-one changes in cost competitiveness because they may only mirror changes in national price level trends. Real effective exchange rates are an effort to adjust for differing national price or cost levels. The International Monetary Fund (IMF) measures real effective exchange rates based on estimates of relative normalized unit labour costs in manufacturing. These series are calculated by dividing an index of actual hourly compensation per worker by an index of output per manhour adjusted so as to eliminate cyclical factors. These estimates of unit labour costs are then expressed as a ratio relative to a trade-

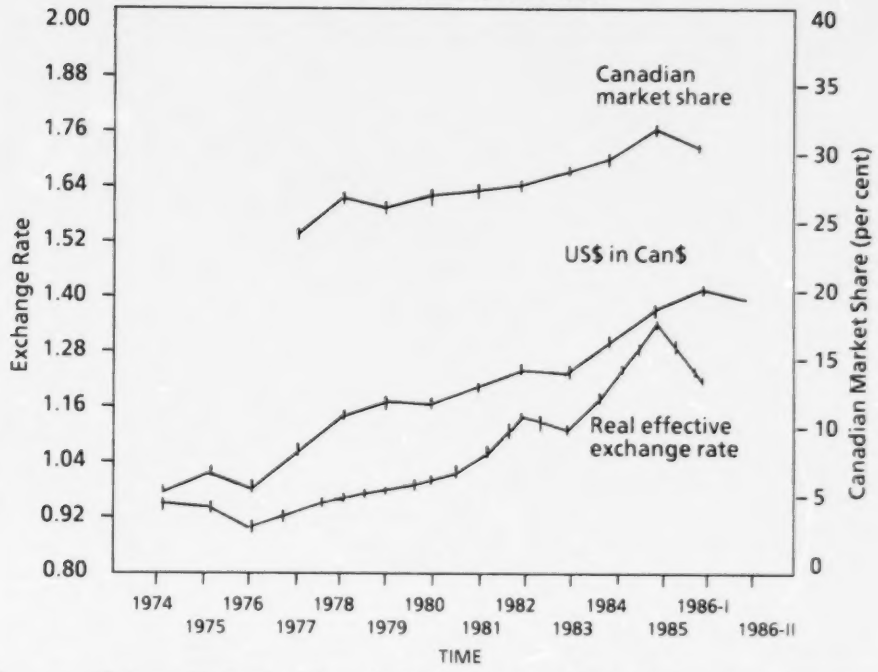
Table 2.7
Exchange Rates and Canadian Softwood Lumber Exports to the United States, 1974-1986

Year	U.S. Dollar in Canadian Dollars (1)	Relative Normalized Unit Labour Costs			Ratio of Canadian Softwood Lumber Imports to U.S. Consumption (5)
		U.S. (2)	Canadian (3)	Ratio of U.S. to Canadian (4)[a]	
1974	0.978	112.4	117.9	0.953	-
1975	1.017	107.3	113.3	0.947	-
1976	0.986	112.1	124.8	0.898	-
1977	1.064	109.7	117.1	0.937	24.3
1978	1.140	101.1	104.2	0.970	26.6
1979	1.172	99.0	101.0	0.979	26.0
1980	1.169	100.0	100.0	1.000	26.9
1981	1.199	111.3	107.5	1.035	27.3
1982	1.234	125.3	110.3	1.136	27.6
1983	1.232	128.7	115.9	1.110	28.5
1984	1.295	138.5	114.9	1.205	29.4
1985	1.365	144.7	108.7	1.331	31.6
1986-I	1.404	122.9	100.8	1.219	30.2
1986-II	1.384	117.5	-	-	-

Sources: (Column 1) *Bank of Canada Review*, August 1986, A1, Series 40 (Ottawa: Bank of Canada, 1987).
(Columns 2, 3, and 4) "Cost and Price Comparisons for Manufacturing," *International Financial Statistics Yearbook 1983* and *International Financial Statistics November 1986* 39, no. 11 (Washington, D.C.: International Monetary Fund 1983 and 1986).
(Column 5) *Softwood Lumber from Canada*, U.S. ITC Publication 1874, July 1986 (Washington, D.C.: U.S. International Trade Commission, 1986), Table 2, A-12

Notes: Dash (-) means not available.
a. Column 2 divided by column 3.

Figure 2.2
Exchange Rates and Canadian Softwood Lumber Exports to the United States, 1974-1986



Sources: (Column 1) *Bank of Canada Review*, August 1986, A1, Series 40 (Ottawa: Bank of Canada, 1987).
(Columns 2, 3, and 4) "Cost and Price Comparisons for Manufacturing," *International Financial Statistics Yearbook 1983* and *International Financial Statistics November 1986* 39, no. 11 (Washington, D.C.: International Monetary Fund 1983 and 1986).
(Column 5) *Softwood Lumber from Canada*, U.S. ITC Publication 1874, July 1986 (Washington, D.C.: U.S. International Trade Commission, 1986), Table 2, A-12.

Notes: Dash (-) means not available.
a. Column 2 divided by column 3.

weighted average of the indicators for 16 other countries, after all of the national indicators have been expressed in terms of a common currency. Real effective exchange rate measures thus offer a comprehensive measure of a country's international competitive position.

The ratio of U.S. to Canadian relative normalized unit labour costs provides a broad-based measure that takes into account exchange rate and production cost movements between the two countries. The estimates of Table 2.7, column 5, suggest that the average competitive position of Canadian exports to the United States improved by over 33 per cent between 1980 and 1985 after movements of exchange rates and production costs are accounted for. The real effective exchange rate appears to track movements in the Canadian share of U.S. softwood lumber consumption very well. The drop in market share in the first quarter of 1986 is paralleled by the fall in the ratio of U.S. to Canadian normalized unit labour costs, i.e., the real effective exchange rate. Thus, movements in the Canadian share of the U.S. softwood lumber market are consistent with movements in real effective exchange rates.

A recent study by Adams et al. (1986) for the 1950-1983 period found that the elasticity of Canadian market share of the U.S. lumber market was approximately 0.4. That is, a one per cent fall in the value of the Canadian dollar would cause a 0.4 per cent increase in market share in the United States. Moreover, a hypothetical simulation for the sub-period 1975-1979 under the assumption of *no* increase in the nominal exchange rate yielded a reduction in Canada's market share to 24.5 per cent in 1979 from its actual level of 27.3 per cent (Adams et al. 1986, 987). Thus, the available econometric and simulation evidence also suggests that softwood lumber exports are sensitive to movements in the exchange rate.

Productivity and Canadian Softwood Lumber Exports

The ability of an exporting industry to expand its market share or, conversely, the ability of an import-competing goods industry to maintain its domestic market depends critically on levels of and growth in productivity. An industry with a rate of productivity growth higher than its international competitors, can profitably sell at lower prices and expand its market share. The evidence suggests that productivity growth in the wood products industries of North America as a whole has lagged behind that of other manufacturing industries but that this is less so in the case of the Canadian wood products industry on its own. Baily (1982, 437) found that the growth rate of the joint (or total) productivity of capital and labour in the U.S.

lumber industry, adjusted for demand fluctuations, fell by 2.63 percentage points per year in the period 1973-1981 relative to the period 1953-1973. The more common but less precise measure of productivity, average labour productivity, fell by 3.34 percentage points per year when the period 1973-1981 is compared with 1953-1973 (Baily 1982, 437). By either measure, the productivity slowdown in lumber between 1973 and 1981 was exceeded only by petroleum refining among all manufacturing industries. For U.S. manufacturers as a whole, the adjusted joint productivity of capital and labour fell by 1.20 percentage points annually and average labour productivity by 1.43 percentage points annually in 1973-1981 relative to the period 1953-1973 (Baily 1982, 432).

This distinct lag in productivity growth in the U.S. lumber industry is large in comparison with that observed for other U.S. industries and would have made it very difficult for the industry to compete in national markets for the services of capital and labour. Poor productivity growth means that the U.S. lumber industry would have problems meeting the return to capital prevailing in other industries while at the same time offering competitive wages to its work force. Profit margins in the industry would have been under severe pressure in the period 1973-1981 as a consequence, and this would have made it difficult to invest heavily in new plant and equipment in an effort to improve productivity.

The evidence for the wood products industry of British Columbia suggests a similar productivity slowdown, but not of the same magnitude as that experienced by the U.S. industry. Denny et al. (1981) have estimated changes in industry productivity by region for the periods 1961-1969 and 1970-1975. Total factor productivity in the wood products industry of British Columbia declined by 1.83 percentage points annually in 1970-1975 relative to the period 1961-1969 (Denny et al. 1981, 396-97). The British Columbia wood products industry was not alone in Canada in experiencing a productivity slowdown. Total factor productivity in the wood products industry in all Canadian regions displayed a slowdown during the 1970s compared with other industries and with its own rates achieved in the period 1961-1969.

Total factor productivity estimates, such as those of Baily (1982) and Denny et al. (1981), are the most comprehensive measure of productivity available. Unfortunately, total factor productivity estimates at the regional level for the Canadian and U.S. lumber industries in the 1980s are not yet available.[6] In their absence we turn to estimates of average labour productivity for the softwood lumber industry, by region, in Canada and the United States.

Table 2.8 provides two different estimates of average labour productivity calculated by the ITC. The first set, published in October

1985, shows average labour productivity higher in Canada than in the United States *and* growing more rapidly than the latter between 1982-1984. These results are consistent with the Canadian advantage of higher productivity growth as the explanation for the increase in Canadian market share of U.S. softwood lumber consumption over the corresponding period.

However, in response to complaints by the U.S. lumber industry regarding the calculations, the ITC provided a revised set of calculations in January of 1986. The new estimates again show a consistently higher level of productivity for the Canadian softwood lumber industry but indicate no *rise* in relative Canadian productivity between 1982 and 1984. The revised results led the Western Canadian Regional Council of the International Woodworkers of America (IWA) to come forth with their own estimates of average labour productivity based on output per hour. These estimates are provided in Table 2.9. The shift to hourly-based productivity measures will influence the estimates of average labour productivity. Employees in the Canadian softwood lumber industry work fewer hours per year than their counterparts in the United States. Accordingly, productivity estimates based on output per employee per year will underestimate the level of average labour productivity in the Canadian softwood lumber industries. In addition, the IWA argued, the ITC adjustment for wood chip production was not correct and biased the productivity estimates against British Columbia. The IWA estimates demonstrate that the level of productivity in Canada exceeded that of the United States in each of the years 1982 and 1984 and that for Canada as a whole it grew more rapidly than in the United States. However, productivity growth (between 1982 and 1984) at the regional level was greatest for Oregon and Washington.

The very high levels of productivity evident in the Interior region of British Columbia reflect the impact of large-scale investments in mill capacity specialized in dimension lumber production along a few product lines. Much of the region's sawmill capacity is new and incorporates production technologies specifically designed for small logs, which constitute much of the timber harvest in the Interior (B.C. 1984, G15-16). The Coast sawmill industry is also building new sawmills designed for the smaller, second-growth timber that will compose much of the harvest as mature timber stocks are depleted. Throughout the 1980s, even when softwood lumber markets were weak in 1982 and 1983, the wood products industries maintained a high level of capital expenditures in efforts to reduce unit labour costs. Between 1980 and 1984 alone, capital expenditures in the wood products industry of British Columbia amounted to $927 million (Council of Forest Industries of B.C. 1986).

Table 2.8
Estimates of Employee Productivity in Softwood Lumber Industry, U.S. and Canada, Various Years
(thousands of board feet per year per employee)

	International Trade Commission Estimates, Oct. 1985			International Trade Commission Revised Estimates, Jan. 1986		
	Canada	United States	Canada/ United States	Canada	United States	Canada/ United States
1977	292	208	1.40	346	275	1.26
1978	286	207	1.38	330	292	1.13
1979	278	199	1.40	331	271	1.22
1980	285	185	1.54	348	248	1.40
1981	269	185	1.45	372	259	1.44
1982	299	209	1.44	401	318	1.26
1983	366	244	1.50	436	369	1.18
1984	382	239	1.60	464	368	1.26

Sources: *Conditions Relating to the Importation of Softwood Lumber into the United States*, Investigation No. 332-210, (Washington, D.C.: International Trade Commission, October 1985), p. 75, and "Refined U.S. and Canadian Softwood Lumber Employment Data," Office of Industries, International Trade Commission, January 1986, p. 4.

Table 2.9
Estimates of Employee Productivity in Softwood Lumber Industry, U.S. and Canada, by Region, 1982 and 1984
(board feet per hour worked)

	1982	1984	% Change
British Columbia	252	309	23
Coast	190	243	28
Interior	294	333	13
Northern Interior	317	427	35
Oregon and Washington	162	222	37
Idaho and Montana	157	183	17
U.S. South	127	132	4
United States	135	154	14
Canada	203	249	23

Source: "Response of the International Woodworkers of America to the U.S. International Trade Commission paper . . . ," Research Department, IWA, 1986.

Thus far the evidence regarding exchange rates, real effective exchange rates (relative normalized unit labour costs), and average productivity levels all support a market-based explanation for the increase in the Canadian share of U.S. softwood lumber consumption. The depreciation of the Canadian dollar combined with superior productivity levels in Canada is a plausible explanation for the observed increase in the Canadian share of the U.S. market. However, that does not rule out the possibility that the alleged "underpricing" of Canadian timber may have contributed to some increase of Canadian exports at the expense of U.S. producers. We now examine the claim that the value of Canadian stumpage is "too low".

Notes

1. An excellent overview of the U.S. procedures involved in the softwood lumber countervailing-duty investigation is found in Canada West Foundation (1986a).

2. For example, the U.S. agricultural sector is not charged the market price for water from federal irrigation projects, and it receives massive subsidies in the form of grants and loans at less than commercial interest rates. Moreover, federal power authorities, such as the Tennessee Valley Authority (TVA), do not appear to set rate structures at commercial levels. During the period of natural gas price controls in the United States, feedstock was priced significantly lower than levels prevailing elsewhere.

3. On October 8, 1986, 40 members of Congress from the Northwest, Southwest and Midwest regions wrote the Trade Representative to warn that a negative preliminary determination by the ITA would "only increase the pressure for a legislated solution." The letter went on to note that Congress's response was "likely to be more far-reaching than the Administration or Canada would like and could jeopardize trade relations with Canada" (*Globe and Mail* 1986c).

4. Lee (1984, Table 1) estimates that in 1981 the value of wood residues represented over 34 per cent of the British Columbia wood products value-added, while the corresponding figure for 1955 was only 4.8 per cent.

5. These trade remedies include: exceptionally high tariffs; escape-clause relief (Section 201 of the Trade Act of 1974); presidential use of inherent constitutional powers; statutory frameworks for discretionary protection; and statutory quotas (Hufbauer et al. 1986, 2-9).

6. Constantino and Uhler (1987, 14-15) in preliminary results find that "In order to explain the penetration of the U.S. softwood lumber market by the B.C. Interior, and also to a lesser extent by Ontario and Quebec, the analysis of the data suggested that in the period 1976-82 the B.C. Interior had a substantial production cost advantage over all other regions considered in the study with Ontario next lowest in costs. During this period, the B.C. Interior's annual percentage growth in production costs was also substantially less than all other regions except for Ontario.

These cost advantages were primarily due to lower factor prices, of which the major component is timber prices, but factor productivity advantages over both Ontario and the U.S. South were important in gaining these important cost advantages.

In all time periods, the PNW [Pacific North West] had a decided factor price disadvantage relative to both the B.C. Interior and Ontario. Although it was able to overcome some of this disadvantage with a higher factor productivity, in the most recent period the exchange rate offset all of its productivity advantage. Thus, with respect to the loss of its U.S. market share to the Canadian producers, factor prices have been of major importance with the exchange rate also playing an important part in the most recent period."

Chapter 3:

The U.S. Department of Commerce Determination of Subsidy, October 16, 1986

The claim that stumpage values are so low that they provide a subsidy to the softwood lumber industry has to be assessed in the context of the U.S. countervail legislation. The legislation requires the imposition of countervailing duties on imports that benefit from foreign domestic subsidies if the International Trade Administration (ITA) determines that the subsidies are given to a specific group of enterprises or industries and the International Trade Commission (ITC) finds the imports have injured the U.S. industry.

"Specificity," "Preferentiality," and the Allegation of Subsidy

The ITA has interpreted current trade legislation to mean that domestic subsidies that are generally available to all industries in an economy are *not* countervailable. This "principle of general availability" is meant to exclude subsidies aimed at promoting the overall growth of an economy from being subject to countervailing duties.[1] The first order of business for the ITA, therefore, is to determine whether a subsidy is of specific or general applicability. Once a determination that a domestic subsidy is specific has been made, the ITA must then assess whether the subsidized good or service is provided at preferential rates to the targeted enterprises or industries. The standard test of preferentiality adopted by the ITA is "whether the government provides a good or service to the producers

of a product at a price that is lower than the prices government charges to the same users or other users of the product within the same political jurisdiction" (51 Fed. Reg. 13272). In cases where the standard case is not applicable, the ITA has developed alternative measures of preferentiality. These measures are discussed shortly.

In the 1983 Softwood Lumber decision the ITA determined that stumpage programs "are not provided only to a 'specific enterprise or industry, or group of enterprises or industries.' Rather, they are available within Canada on similar terms regardless of the industry or enterprise of the recipient" (48 Fed. Reg. 24159-167). Crown timber was found to be available to a variety of users, and technological considerations *not* government policy limited it to industrial uses. The next issue addressed was that of preferentiality. The ITA determined that "even if stumpage programs were being provided to a 'specific group of . . . industries' we determine that they do not provide goods at preferential rates to the producers of the products under investigation . . ." (48 Fed. Reg. 24167). On both counts, therefore, these findings regarding specificity and preferentiality required the ITA to reject the imposition of countervailing duties on softwood lumber imports from Canada.

However, the interpretations of both the specificity and preferentiality requirements employed by the ITA have evolved since 1983 in the face of mounting criticism by the Court of International Trade (CIT), Congress, and various interest groups. The persistence and importance of the issue of resource input subsidies referred to in the Introduction has been the catalyst for change. Various foreign governments have adopted two-tier pricing systems for natural resources in the public domain, and this has led to export prices pegged at world levels and domestic prices maintained artificially low to encourage further domestic processing. Mexico, for example, adopted this strategy in pricing its energy resources, and during the 1980s several of its energy-intensive industries dramatically increased their exports to the United States. What made Mexico a particular focus of criticism was that the two-tier pricing system was combined with restrictions on foreign ownership in its energy sector. In response, competing U.S. producers argued before the ITA and ITC that Mexican energy-intensive exports were subsidized because of the low internal prices of energy.

Shortly following its negative determination in the Softwood Lumber case in 1983, the ITA, in several cases involving Mexican energy-intensive exports, upheld its doctrine of general availability. It rejected the imposition of countervailing duties on these Mexican exports on the grounds that low domestic energy prices were generally available to all users and therefore were not countervailable.

In response to criticism from the courts and Congress that is outlined more fully in Chapter 4, the ITA modified somewhat its controversial interpretation of the specificity test. The test had been criticized on the grounds that a domestic subsidy might be nominally available to all potential users but technological considerations would restrict its benefit to a few actual users. In its final determination on the Carbon Black from Mexico case in 1986, the ITA found that the absence of other actual purchases of a subsidized good or service meant that the specificity test was satisfied. The argument that technical considerations, not government policy, restricted the use of the good or service in question to a few users even though it was nominally available to all *potential* users has apparently ceased to be a valid defence against the specificity test. Furthermore, the exercise of government discretion in the allocation of an allegedly subsidized good or service is also evidence of specificity. Thus, the number of actual enterprises or industries using a good or service subject to countervail investigation and the degree of government discretion in the allocation of that good or service are now both important considerations in the application of the specificity test.

The usual and preferred test of preferentiality employed by the ITA is "whether the government [or government-directed suppliers] provides a good or service to the producer(s) of a product at a price that is lower than the price the government charges to the same or other users of that product within the same political jurisdiction" (51 Fed. Reg. 13272). This test is effectively one of assessing whether the foreign government practises price discrimination for the good within the domestic economy. However, the choice of the appropriate benchmark to measure preferentiality has been a contentious issue, especially when two-tier pricing policies are involved in the investigation or when the good in question is limited to a few actual users. In the case of government-owned natural resources, for example, it is difficult to find a price for the allegedly subsidized good other than that charged to enterprises or industries that have been deemed targeted. The inherent characteristics of resources or their derivatives often restrict their use to a limited number of users, all of whom may be the subject of investigation.

In April of 1986, as a result of an administrative review of the Carbon Black from Mexico case, the ITA proposed four alternative tests to measure preferentiality in those cases where the producers under investigation are the only users within the foreign jurisdiction. The tests, ranked in order of priority that the ITA will give the benchmark criteria, involve comparing the price of the allegedly subsidized good or service to:

1. prices charged by the same seller for a similar or related good
2. prices charged within the jurisdiction by other sellers for an identical good or service
3. the same seller's cost of producing the good or service
4. external prices, such as export prices or a commercial price in an external market that resembles the market in question

The ranking of these alternative tests reflects the ITA's stated belief that comparisons of prices within the foreign jurisdiction are the most appropriate measures of preferentiality. The use of external prices, alternative 4, is considered the "least desirable and most deficient because regardless of which external price is chosen for comparison purposes, a domestic subsidy is no longer being defined by its effect on the domestic market. This test does not measure preference *within* an economy" (51 Fed. Reg. 13272, emphasis added).

Producer groups initiating countervail proceedings in the United States view external price comparisons, especially cross-border comparisons, as the most appropriate benchmark. The use of cross-border comparisons permits the subsidy to be defined in terms of U.S. prices rather than undistorted foreign domestic prices or the next best approximation that the ITA can derive. In the cases involving Mexican energy pricing policies, U.S. petitioners before the ITC and ITA have vigorously advocated cross-border price comparisons as the best measure of cost advantages enjoyed by their Mexican competitors. Similarly, in the case of Canadian softwood lumber, in the 1986 countervail proceedings the U.S. Coalition, like the petitioners in the 1983 case, emphasized cross-border stumpage comparisons as evidence of subsidy. The ITA has thus far consistently rejected cross-border comparisons, as it did in its preliminary determination (October 16, 1986) of subsidized stumpage in the 1986 Softwood Lumber case.

The ITA Finding of Subsidized Stumpage, October 16, 1986

The October 16, 1986, preliminary determination of the ITA that Canadian timber is subsidized because it is provided at preferential prices to a specific industry or group of industries represents the opposite of the 1983 negative determination. The issue of specificity was decided on the grounds that the Crown in each of the four provinces exercised discretion in the allocation of stumpage and skewed its distribution in favour of lumber producers. Discretion had not been an issue raised in the 1983 ruling. But in the 1986 decision it was an underlying rationale. For example, licence requirements, which, it was alleged, linked the allocation of harvest rights to the use

of timber in sawmills, were treated as evidence of targeting. Moreover, the ITA argued that in order to be considered targeting, the discretion need not lead to the exclusion of all other users. It is sufficient that an industry have greater access to the good in question than in the absence of discretion.

The ITA then proceeded to reassess its earlier finding of general availability. It had found in 1983 that, since the actual number of users of stumpage was large, the "general availability" criterion was satisfied. The ITA now claimed that one industry, the furniture industry, included as holding stumpage rights in 1983, in fact held negligible stumpage rights. Moreover, the argument was made that the high degree of vertical integration that exists between lumber and pulp and paper firms called into question their treatment as two distinct industries for the purpose of stumpage allocation. This line of reasoning led the ITA to claim that the market for timber basically consisted of one industry.

In the October 16, 1986, determination, the ITA then concluded that timber was provided at preferential prices to a specific group of enterprises or industries. Interestingly enough, the test for preferentiality was not based on the preferred test of price discrimination within the jurisdiction. The ITA argued that although British Columbia and Alberta did sell timber through competitive bidding, the prices obtained were not an appropriate benchmark for assessing preferentiality. In the case of British Columbia, bidding was restricted to a small proportion of the harvest and the obligations associated with these contracts differed from those of the dominant forms of tenure in the province. Moreover, in both British Columbia and Alberta, stand quality and the obligations of timber users were viewed as differing too much between timber allocated competitively (i.e., by bidding) and non-competitively (.ie., administratively) for the former price to be used as a market benchmark. Furthermore, the ITA claimed that Crown control in the market for stumpage was so great that it may have influenced the competitively bid value of stumpage.

To measure preferentiality, the ITA relied instead on the alternative tests set out in the administrative review of the Carbon Black from Mexico case. The first alternative – using prices charged by the same seller for a similar or related good – was rejected. The only good similar to softwood timber is hardwood timber and its use is limited to the very users under investigation. The second alternative – using prices by other sellers for an identical good or service – was also rejected. Data on private sales were too meagre and, as in the case of the preferred test of price discrimination within the jurisdiction, the government presence in the market for timber may have distorted the bid price of sales.

The ITA chose the third alternative – the government's cost of producing the good or service in question – as the appropriate test for preferentiality. The ITA included two measures of cost incurred by governments in "producing" timber. The first set of costs are those that are directly related to providing timber to commercial users. These costs, by the ITA reckoning, include virtually all expenditures by provincial forestry ministries, including administrative overheads, road costs, scaling and inventory costs, small-business development programs, and reforestation expenditures. The second component of costs was an imputation for the "intrinsic value of land." This imputation for the value of standing timber was then applied to the provincial harvest. In the case of British Columbia and Alberta, the competitive bid prices obtained for the small proportion of the government stumpage allocated in this fashion served as the proxies for the imputed value of timber. For Ontario and Quebec, prices from private sales in New Brunswick was employed as proxies. The revenues applied against these two sets of costs included all royalties, timber fees, stumpage payments, and user fees imposed by the provincial forestry ministries. Using these cost and revenue measures, the ITA found that costs substantially exceeded revenues and that, therefore, in accordance with its third criterion, preferentiality was established.

By the ITA calculation, direct expenditures by the provinces on the provision of stumpage to commercial users exceeded revenues by over $543 million. The imputed value of stumpage evaluated at bid prices totalled $702 million. The total subsidy by their calculation amounted to $1.245 billion ($543 million plus $702 million) or $10.22 per cubic metre for the 122 million m^3 of timber harvested in 1985. The volume of sawlogs harvested was 90.2 million m^3 of which 77 per cent was recovered as lumber. The 1985 value of softwood lumber shipments totalled $4.9 billion. The *ad valorem* subsidy of 14.5 per cent was calculated as the product of the subsidy per cubic metre, the sawlog harvest, and the lumber recovery factor all divided by the 1985 value of lumber shipments.

An Economic Analysis of the ITA Preliminary Determination

The economic reasoning underlying the preliminary determination of the ITA is seriously flawed. The findings of specificity and preferentiality appear contrived to achieve some target level of duty acceptable to both parties in the dispute – low enough not to cause serious harm to the Canadian producers but high enough to provide some degree of protection to the U.S. industry. The U.S. Congress was perhaps the major audience to whom the decision was directed. The

positive determination was a clear signal that remedies under existing trade legislation were sufficient to address concerns regarding alleged subsidies and that new, and probably more protectionist, legislation was not required. Unfortunately this signal was not picked up by either the House or the Senate in the subsequent session of Congress. The early months of the 100th Congress saw the introduction of a variety of protectionist bills, some of which have been discussed in the Introduction.

Specificity and the Notion of Discretion

Two aspects of the specificity, or lack of general availability, finding warrant discussion. First, the treatment of government discretion is both puzzling and ominous in its implications for other Canadian industries dependent upon Crown-owned resources. The decision suggests that any exercise of the sovereign right of Canadian governments to set terms and conditions of access to Crown resources justifies the finding of specificity for the program or policy under investigation in countervail proceedings. The ITA cites alleged instances of skewing of timber allocation to the sawmilling industry. However, these instances appear to reflect far more the inherent uses of timber rather than a requirement to process it for a particular market or product.[2] In some instances a condition of tenure or allocation of annual allowable cut was that the resource *be harvested*. But it was the characteristics of the wood – species, quality, size, and end-product prices – that determined the ultimate allocation of timber among competing uses in the wood products and pulp and paper industries. No targeting of timber to specific products or markets was involved in the tenure constraints.

The view of the role of government in resource management embodied in the ITA determination is simplistic in the extreme. Discretion *per se*, rather than targeting, seems to be the issue at stake. Yet the reality is that government intervention or so-called "exercise of discretion" in resource markets is pervasive in many countries, and rightly so. Indeed, any owner of private property in North America has a wide discretion over its sale. Discretion is axiomatic to ownership.

Many resource markets are characterized by market failure – i.e., the private costs and benefits of individual actions differ from those that accrue to society. Unregulated market forces may yield undesirable outcomes from the perspective of society. Government, in its role as regulator, has responsibility for ensuring that socially desirable management of the forest base is achieved. Non-market benefits of the forest base – such as wildlife habitat, aesthetic or wilderness values, erosion control, and water flow – are

neglected in the private market's valuation of the resource base. Consequently, in the absence of government intervention timber harvests might be too large relative to the socially desirable level. Moreover, neglect of non-timber benefits would also lead society to underinvest in the future forest timber resource because it would underestimate the stream of benefits from such investments.

Another rationale for government intervention is the argument that market discount or interest rates are not appropriate for evaluating investments, such as those in forestry, which have such a long term to pay-off. Market interest rates are viewed as being too high relative to society's true willingness to trade off current against future consumption, and this consideration is especially relevant when evaluating long-term investments. Use of too high a discount rate in decision-making would "tilt" consumption or harvesting to the present, at the expense of future harvests, and would lead to underinvestment in the forest base.

Society may also wish to manage a resource to achieve other objectives deemed desirable but perhaps not justified on the basis of market failure. Sustained-yield forest management is often justified on the grounds of promoting community stability. Interruptions of timber supply have the potential for creating serious economic hardships for single-industry, forest-based communities. The mechanism for ensuring a continuous flow of timber from the forest is to regulate harvest levels and to promote reforestation of cut-over areas. British Columbia, for example, specifies the annual allowable cut permitted under a variety of tenures and requires that over a five-year period the actual average harvest be within 10 per cent of the allowable annual cut. Reforestation to a basic standard is also required, but the industry can claim the costs as a credit against stumpage payments owed the Crown.

Provinces in Canada, the U.S. Forest Service, and some American states also impose restrictions on the export of logs. The object of these policies is to promote domestic processing of the timber and to create additional value-added and employment within the region. A common view expressed by advocates of these restrictions is that the export of unprocessed materials is equivalent to exporting processing jobs.

Sustained-yield policies and export restrictions are often criticized by economists on the grounds that these policies do not lead to an economically efficient allocation of society's scarce resources and result in lower aggregate incomes. Yet policy-makers and the voters who continually re-elect them have adopted and maintained such policies because they yield a distribution of income which is viewed as desirable and worth achieving even at the cost of a less efficient allocation of resources. The Crown, in its role as resource owner and

regulator, has both the right and the need to intervene in the management of the forest base. Such intervention can be justified as a response to certain goals deemed desirable by society and as an effort to correct instances of market failure.

There is absolutely no model of government behaviour embodied in the preliminary Softwood Lumber determination. No benchmark is provided for evaluating the exercise of government discretion other than to note that "... the provinces have not demonstrated that their discretionary allocation systems do not provide lumber producers a greater share of the annual allowable cut than they would have received absent the discretion" (U.S. Dept. of Commerce 1986, 15). Yet when market failure exists, or society as a whole views a certain distribution of income or industrial structure as desirable, then the exercise of discretion by a government is its sovereign right as both resource owner *and* regulator. The ITA definition of which kind of government discretion represents targeting is sufficiently broad in scope to justify a finding of specificity whenever desired by the U.S. Department of Commerce.

Specificity, Industry Definition, and the Actual Number of Users of Stumpage

In the preliminary determination of October 16, 1986, the ITA also reconsidered its 1983 finding that timber satisfied the criterion of general availability. In 1986 the ITA appeared to be arguing that the allocation of timber no longer satisfied this criterion. Had the ITA not found that the specificity test had been met because of the exercise of government discretion, it would have done so on the grounds of lack of general availability. The absence of the furniture industry as a holder of tenure rights to timber and the high degree of integration between the wood products and pulp and paper industries were used to justify the claim that the actual number of industries using timber was small. The issue of the furniture industry is a red herring, as it is unlikely that it ever held more than negligible stumpage rights, even in 1983. Comment is warranted, however, by the argument that vertical integration between two industries, such as the wood products and the pulp and paper industries, requires that they be treated as one industry for the purposes of assessing general availability.

The logical approach in assessing the diversity of industrial users of stumpage is to employ the Standard Industrial Classification (SIC) to allocate uses by industry. The basis for classifying industries is similarity on the production side rather than the degree of substitutability on the demand side of the market. An industry in the SIC classification "consists of a group of establishments primarily engaged in the same activity" and which meet "certain criteria of

economic significance" related to employment, value of industry shipments, or number of establishments (51 Fed. Reg. 5663-64). The single-digit SIC category is reserved for very broad industry definitions, and two-digit categories for industrial sectors within one-digit classes. The three- and four-digit categories subdivide industries even further. Once the five-digit SIC category is reached, one is virtually dealing with individual product classes.

In the 1983 case the Department of Commerce found that under both the U.S. and Canadian SIC systems, timber users "constitute at least three groups of industries" (48 Fed. Reg. 24167). At the two-digit (major group) SIC level, these industries were wood products (including lumber), pulp and paper, and furniture. Once the three- and four-digit level is reached there is a multiplicity of stumpage users – sawmills and planing mills, shingle mills, veneer and plywood mills, sash door and other millworks, to name a few. Under neither the Canadian nor the U.S. SIC categories is there an entry for a "forest products" industry encompassing the forestry, wood products, and paper and allied products industries. Such a classification is considered too broad *even* at the one-digit SIC level.

When provincial governments attempted to respond to requests by the ITC and ITA for estimates of the volume of timber allocated to softwood lumber producers, one problem the provincial governments faced was that they did not have such data in their possession. The provinces do not allocate the allowable annual cut on the basis of targeting a specific share to a particular industry. Firms have rights to timber, but they must satisfy annual allowable cut restrictions and, on the basis of prevailing prices for end-products derived from timber, they allocate timber among competing uses. It is impossible in most circumstances for a province, *ex ante*, to know the specific end-use of timber harvested. Once firms have determined their product mix in response to prevailing market signals, it is possible to work backwards from end-products to the amount of timber used in their production.

Table 3.1 provides an estimate of the allocation by end-use of the Crown timber harvested in British Columbia in 1984-1985. Approximately 22 per cent of the harvest was used in the production of dimension softwood lumber, the product at the centre of the Softwood Lumber dispute. The single largest use of softwood timber was in the production of bleached kraft market pulp. The range of users of stumpage spans a number of three- and four-digit SIC categories and two major group (two-digit) SIC categories – wood products industries, and paper and allied products industries.

The assertion that some degree of economic integration of two industries warrants, under some circumstances, defining them as a single industry is difficult to justify. The wood products and pulp and

Table 3.1
British Columbia Crown Timber Harvest by End-Use, 1984-1985
(thousands of cubic metres)

	Softwood Timber		Hardwood Timber
	Volume	%	Volume
Bleached kraft mkt pulp	16,135	23.5	
Unbleached kraft mkt pulp	295	0.4	
Sulfite paper grade mkt pulp	55	0.1	
Dissolving mkt pulp	515	0.8	
Mech./chemi-mech. mkt pulp	515	0.8	
Newsprint	3,540	5.2	
Groundwood specialties	920	1.3	
Linerboard	1,145	1.7	
Corrugating medium	50	0.1	
Kraft papers	985	1.4	
Bleached board	50	0.1	
Tissues	-	-	40
Printing/writing papers	75	0.1	
Dimension lumber	14,835	21.7	5
Clear/shop sawn products	765	1.1	
Rough sawn for offshore exp.	1,885	2.8	
Pallets and skids	40	0.1	
Secondary lumber products[a]	325	0.5	
Specialty sawn products			
W. red cedar	1,805	2.6	
Yellow cedar	165	0.2	
Sitka spruce	160	0.2	
Treated wood products	125	0.2	
Railway ties	90	0.1	
Sanded plywood	300	0.4	
Sheathing plywood	1,160	1.7	
Specialty plywood	85	0.1	
Particleboard	215	0.3	
Hardboard	100	0.1	
Veneer cores (as such)	230	0.3	
Shingles	450	0.7	
Shakes	615	0.9	
Export chips	2,940	4.3	
Export logs	2,685	3.9	95
Poles, piling, posts & misc.b	890	1.3	85
Hog fuel and similar fibre	12,855	18.9	
Unallocated/inventory change	1,420	2.1	
Total Harvest	68,420	100.0	225

Source: *End Use Estimates for Canadian Timber Harvest 1984/85*, Appendix II, Memorandum of Canadian Forest Industries Council concerning the Alleged Stumpage Subsidies, September 10, 1986.

Notes: a. Panelling, finger-jointed lumber, edge-glued stock, moulding, etc.
b. Includes fuelwood.

paper industries are vertically integrated because it is economically efficient to do so and leads to superior productivity. The productivity advantage enjoyed by the lumber mills in the Interior and Northern Interior of British Columbia reflects the pay-off to producing both dimension lumber for other wood products and residual chips for the pulp and paper industry. Yet the two industries do *not* share a common production technology, their products are dissimilar, and they compete in different markets. Nor does the existence of "horizontal" integration—in the sense of drawing upon the same timber base—justify aggregating the industries together. This so-called horizontal integration does not offset in any way the fact that the two industries employ different production technologies and compete in completely different markets. Moreover, workers in the pulp and paper industry and in the wood products industry of British Columbia are represented by different unions, while the firms in the two industries belong to different trade associations. By any economic criteria for defining industries, the pulp and paper industry and the wood products industry constitute two identifiably different, major industries.

The implausibility of the ITA treatment of the two industries becomes apparent once we look at its implications. For example, by this ITA criterion separate divisions of a large conglomerate could easily be considered to fall within a single industry, despite the fact that they might span a variety of two- or three-digit SIC categories. Common access to financial capital and to management teams, the overlap in boards of directors, plus any degree of vertical integration would, in light of the 1986 preliminary determination in softwood lumber, constitute grounds for treating the conglomerate as competing in a single industry.

Perhaps more importantly, the preliminary determination has implicitly found the pulp and paper industry guilty of using a subsidized input, "underpriced" Crown timber, without letting the industry offer a defense. A countervail petition by pulp and paper industry groups in the United States is virtually invited by this determination. When the wood products and pulp and paper industries are treated as one for the purposes of determining specificity or targeting, there is the obvious implication that if softwood lumber exports to the United States are deemed subsidized so too must pulp and paper exports.

Preferentiality and the Value of the Alleged Subsidy

The procedures adopted by the ITA to measure the value of the alleged subsidy are seriously deficient. The empirical and theoretical shortcomings of the "analysis" are glaring and cast doubt upon the

impartiality of the ITA. Most notably, imputing a value for the "intrinsic value of land" and then adding this to the value of provincial expenditures on commercial timber harvesting represents double counting that nearly doubles the magnitude of the alleged subsidy.

At the heart of the matter is whether the stumpage assessed by the British Columbia government reflects the true market value of the standing timber. If the province's administratively determined pricing mechanism, the stumpage formula, does capture the market value of standing timber then it has in fact realized the intrinsic value of the forest base. The following hypothetical example illustrates the fallacy of the ITA methodology of double counting what are essentially alternative measures of economic rent. Let us assume that the value of bids for timber and the value of stumpage determined by the administrative pricing mechanism yielded *exactly* the same value for equivalent stands. Under the ITA procedure the two values would always exactly cancel each other out. The revenues received by the province through stumpage payments would offset completely the imputation on the expenditure (cost) side of the balance sheet for the intrinsic value of the forest base. Therefore, the province would always appear to be "subsidizing" timber production because the expenditures undertaken by the forest service to maintain and manage commercial timber harvesting would not appear to generate any revenues. The ITA has thus loaded the case against the provinces and in favour of the finding of subsidy.

The correct approach in theory to assessing whether the stumpage formula yields the market price of standing timber would be to compare stumpage values calculated administratively (using the formula) with those obtained through competitive bidding for stands of equivalent characteristics and management responsibilities. Any shortfall of the stumpage formula value from the bid value would indicate that the province was failing to capture the full market value of the standing timber. This wedge, if it existed, would be an appropriate measure of "underpricing." Unfortunately no such controlled experiments are possible in British Columbia precisely for the reasons outlined earlier by the ITA.

A further problem with the ITA calculation is that it exaggerates the cost to the provinces of maintaining and promoting the current commercial timber harvest. For example, included as government expenditures are a number of items unrelated to the commercial timber harvest. Some portion of the expenditure on road access, for example, is to ensure the recreational use of the forest base and should not be charged fully against commercial timber. The same argument holds for that portion of fire-fighting expenditures directed to fire

suppression in provincial parks, recreational areas, and other non-commercial timber areas.

A more contentious issue in assessing legitimate costs against the commercial timber harvest is the treatment of reforestation expenditures. Many foresters view expenditures on so-called basic and intensive silviculture as charges against the current harvest that should be covered by current stumpage payments. Some economists, on the other hand, would claim this argument is not correct. Rather, investments in basic and intensive silviculture are like any other investment and should be evaluated in similar fashion: if the present value of the future net benefits from an investment in the forest base is positive, the investment should be undertaken and can be justified in terms of future stumpage revenues relative to current costs. The decision to invest in future timber supplies should be based on its own economic merits and should not influence the level of current stumpage values. Thus, some economists would argue that reforestation expenditures should *not* be included as costs charged to the current commercial timber harvest.

If the ITA preferentiality test is correctly applied – with double counting eliminated and only legitimate costs against the commercial timber harvest included in provincial forest service expenditures – there is no evidence of subsidy. Table 3.2 provides estimates of "corrected" expenditures and revenues as reported by the provinces in the countervail investigation. The evidence indicates that revenues generated by the commercial timber harvest exceed expenditures for all the provinces. One interesting side note is that the U.S. Forest Service itself does *not* pass the "government cost of production" test for preferentiality as applied by the ITA (even excluding the erroneous imputation for an intrinsic value). Clawson (1983, 293-94) provides data for the National Forest Service for 1980 showing forest service expenditures of $1.7 billion and total cash receipts equalling $1.3 billion.

Cross-Border Comparisons of Stumpage and the Issue of Subsidy

Many observers on both sides of the border claim that British Columbia subsidizes timber production because its stumpage values are so much lower than those prevailing in roughly comparable regions of the United States. For example, one U.S. congressman placed relative timber costs between Canada and the United States in the following context: "our companies pay $100; theirs pays $10; if that's not a subsidy I don't know what is" (cited in Melrose et al. 1986, 13). The evidence collected by the ITC and presented in Table 3.3, Panel A, certainly indicates that British Columbia's timber prices

Table 3.2
Provincial Expenditures and Revenues from Current Commercial Timber Operations, 1983-1986
(millions of CAN$)

Fiscal Year	1983-84	1984-85	1985-86
Alberta			
Expenditure	2.7	2.2	n.a.
Revenues[a]	16.8	28.4	n.a.
Net income	14.1	26.2	n.a.
British Columbia			
Expenditures	74.7	81.2	82.3
Revenues[a]	191.2	187.3	209.1
Net income	116.5	106.1	126.8
Ontario			
Expenditures	19.4	19.5	21.2
Revenues[a]	46.7	59.4	68.6
Net income	27.3	39.9	47.4
Quebec			
Expenditures	26.6	27.6	23.3
Revenues[a]	34.9	47.5	45.8
Net income	8.3	19.9	22.5

Source: *Memorandum of Canadian Forest Industries Council Concerning the Alleged Stumpage Subsidies*, Sept. 10, 1982, p. 113. [The data are derived from provincial government responses to a U.S. government questionnaire.]

Notes: *n.a.* means not available.
a. Does not include revenue from logging and corporate income taxes or certain in-kind services.

Table 3.3
Cross-Border Comparisons of Delivered Log Costs, Various Years
(Canadian prices/costs as percentage of U.S., per thousand board feet)

	1980	1982	1984
Panel A			
Unadjusted Canadian Stumpage Prices[a]			
Canada vs. United States	22.5	11.3	11.4
British Columbia vs. U.S. West	25.6	8.9	10.3
Interior British Columbia vs. U.S. South	18.7	8.0	6.9
Panel B			
Canadian Delivered Log Prices[a]			
Canada vs. United States	68.4	89.4	81.0
British Columbia vs. U.S. West	73.3	89.9	90.5
Interior British Columbia vs. U.S. South	84.4	113.1	85.6
Panel C			
Adjusted Canadian Delivered Log Costs[b]			
Vancouver Forest Regions vs. Mt. Baker Working Circle	94	103	97
Nelson Forest Region vs. Kootenai/Panhandle National Forest	94	112	102
Queen Charlotte Islands vs. Ketchikan Administrative Unit	110	110	143

Sources: (Panel A and Panel B) *Conditions Relating to the Importation of Softwood Lumber into the United States*, Investigation No. 332-210 (Washington, D.C.: U.S. International Trade Commission, 1985), pp. 59-61.

(Panel C) "Cross-border Comparisons of Indicated Delivered Log Costs for 1985," Supplementary Joint Report to Canadian Forest Industries Council (Sterling Wood Group Inc.; Darveau, Grenier, Routhier and Associates Inc.; and Wesley Rickard Inc.), September 1986.

Notes: a. Canadian prices as percentage of U.S. prices.
b. Canadian costs as percentage of U.S. costs.

(stumpage) are much lower than those in the United States. In 1984, British Columbia's average stumpage values amounted to 10.3 per cent of those in the U.S. West.

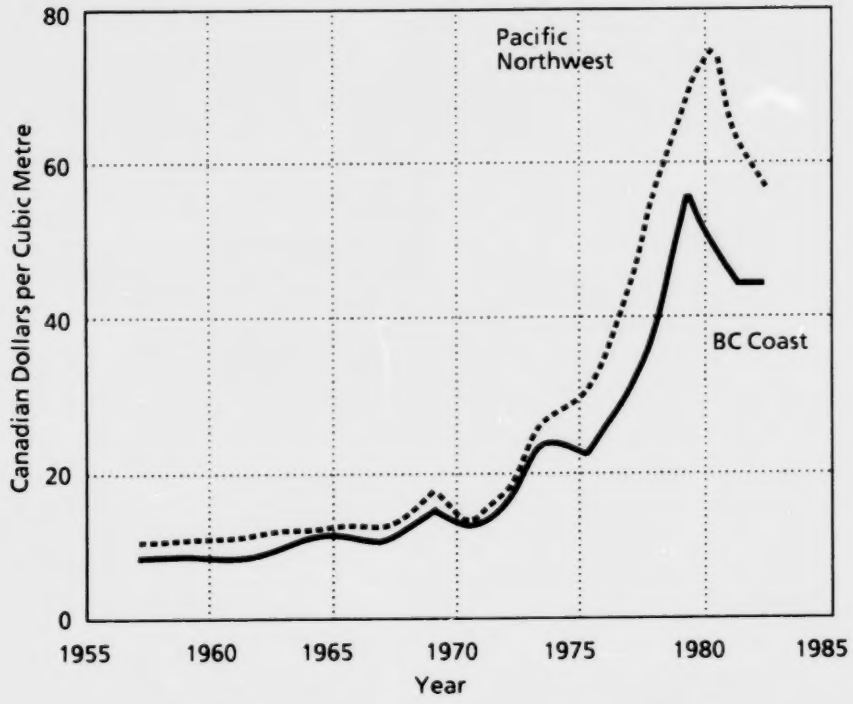
Simple comparisons of stumpage values between Canada and the United States can be seriously misleading, however, as even the ITC and the ITA have acknowledged. The Department of Commerce stated in its 1983 softwood decision that:

> we believe that a comparison of Canadian stumpage prices with U.S. prices would be *arbitrary and capricious* in view of: (1) the wide differences between species composition; size, quality and density of timber terrain and accessibility of the standing timber throughout the United States and Canada; (2) the additional payments which are required in many provinces in Canada, but not generally in the United States; (3) the fact that in recent years, prices in national forests in the United States have been bid anywhere between two to five years in advance of cut, without taking into account the fluctuations in demand for lumber; and (4) the fact that in recent years the U.S. Forest Service has restricted the supply of timber in certain national forests due to budgetary and environmental constraints. (48 Fed. Reg. 24168, emphasis added)

Once we turn to delivered log prices, much of the apparent disparity between Canada and the United States disappears. Table 3.3, Panel B, contains ITC estimates of average delivered log prices in Canada as a percentage of U.S. price. Higher logging costs brought about by terrain and species mix, higher labour and capital costs, and greater distance from market compensate for much of the difference in stumpage prices and are reflected in the convergence of average delivered log costs in Canada and the United States. Once differences in species mix, management responsibilities, and other costs are taken into account, delivered wood costs virtually converge and are sometimes higher in Canada than in the United States, as Panel C of Table 3.3 indicates.

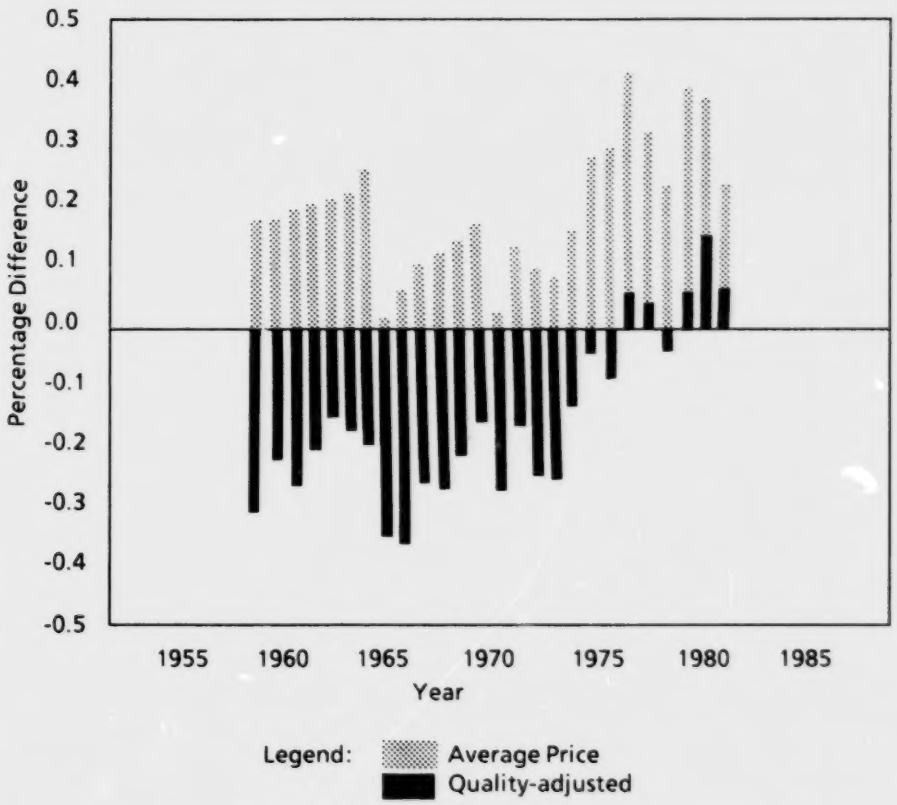
A recent study (Constantino 1985) demonstrates the importance of quality differences in comparing stumpage between Canada and the United States. Figure 3.1 illustrates average log market sawlog prices in coastal British Columbia (the Vancouver log exchange) and the Pacific Northwest. Beginning in 1974, average log market prices in the Pacific Northwest grow more rapidly and after 1979 fall less than those in British Columbia. Figure 3.2 illustrates what happens once quality differences in the timber mix are taken into account. The average price in the Pacific Northwest reflects a much larger

Figure 3.1
Average Log Market Sawlog Prices,
British Columbia Coast and Pacific Northwest



Source: Luis Constantino "Sawlog Prices and Quality Differences in Canadian and United States Pacific Coastal Log Markets," Forest Economics and Policy Analysis Project, Report 85-6 (University of British Columbia, Vancouver, B.C.)

Figure 3.2
Percentage Differences, Average and Quality-adjusted Sawlog Prices, Pacific Northwest Relative to British Columbia



Source: Luis Constantino "Sawlog Prices and Quality Differences in Canadian and United States Pacific Coastal Log Markets," Forest Economics and Policy Analysis Project, Report 85-6 (University of British Columbia, Vancouver, B.C.)

proportion of higher-valued species than is found on the Vancouver log market in British Columbia. Once quality mix is incorporated into the analysis, much of the apparent difference between the Pacific Northwest and the Coast of British Columbia is removed.

One point often overlooked when Canada-United States comparisons of stumpage values are undertaken is that variations in stumpage are equally as large within the United States as they are between the two countries. Table 3.4 provides the average stumpage values for timber harvested in the western United States from federal timber lands. These data clearly indicate both the tremendous volatility of stumpage prices over time and their variation between regions. It is instructive to note that regions distant from markets, such as the Rocky Mountain and Intermountain regions and Alaska, have low average stumpage values. Moreover, the Rocky Mountain and Intermountain regions, which tend to have a much greater proportion of lower-valued species, also have lower stumpage prices in comparison with the Pacific Northwest. The negative value of stumpage in Alaska in 1985 reflects the fact that the costs of road construction more than offset the value of the timber harvested.

Timber Appraisal and the Stumpage Formula—British Columbia vs. United States

The Forest Service of British Columbia and the U.S. Forest Service both employ what is called the Rothery formula to determine the value of standing timber. However, beyond this common feature the similarities end. The Rothery or stumpage formula calculates the value of standing timber as the difference between the end-product value of timber, and the combined sum of harvesting costs and an allowance for profit and risk. The residual value is the value of standing timber, which is often referred to as economic rent or the return to the forest base. In British Columbia, the end-product value for the Coast region is based on the prices of logs prevailing in the Vancouver log exchange, while in the Interior it is based on prices of dimension lumber and chips. Consequently, for the Interior, processing costs in addition to harvesting costs enter the calculation.

An outstanding and desirable feature of the stumpage formula is its sensitivity to differences in end-product prices and in harvesting and processing costs. Timber species that yield higher valued end-products will have higher stumpage prices than, say, timber suitable only for pulpwood. Distance from end-product markets also influences stumpage prices: British Columbia producers in most cases bear the burden of transportation costs in the form of lower end-product prices, which in turn are reflected in lower stumpage prices. Differences in terrain influence harvesting costs and are also related to stumpage

Table 3.4
Average Value of Stumpage of All Species Harvested, Western United States, by Region, 1977-1985[a]
(US$ per thousand board feet)

	Northern Region	Rocky Mountain Region	Southwestern Region	Intermountain Region	Pacific Southwest Region	Pacific Northwest Region	Alaska Region
1977	43.25	16.72	52.82	51.95	90.81	106.25	3.82
1978	50.55	17.85	66.16	32.23	102.41	131.47	4.37
1979	54.46	15.27	64.72	48.16	100.08	135.53	4.38
1980	35.97	11.48	44.27	24.06	86.82	125.36	16.42
1981	36.53	12.15	53.63	21.62	95.71	118.44	13.20
1982	22.39	6.97	25.29	11.13	47.80	75.05	14.86
1983	38.15	10.48	42.52	44.06	97.71	95.81	10.01
1984	40.89	13.80	31.14	17.16	80.13	95.58	14.91
1985	36.70	13.47	45.80	17.47	72.82	87.00	-10.47[b]

Source: Debra W. Warren, "Production, Prices, Employment, and Trade in Northwest Forest Industries, Fourth Quarter 1985," Resource Bulletin PNW-130 (Washington, D.C.: U.S. Dept. of Agriculture Forest Service, April 1986), Table 44.

Notes: a. The regions are those of the U.S. Department of Agriculture Forest Service.
b. Negative stumpage value caused by emergency rate determination.

prices. The residual pricing mechanism ensures that forest services do not charge too much for low-value species or stands which are less accessible and do not charge too little for valuable species or those easy to harvest. The stumpage formula is more effective at protecting the proprietary rights of the collective owners of the forest base – the residents of the province – than is, say, a flat-rate royalty levied as a charge on each cubic metre of timber harvested. A flat-rate charge, invariant to end-product prices or harvesting costs, discriminates against the harvesting of economically marginal stands and fails to capture all the returns to the forest base from those stands that are more valuable or accessible.

Despite the use of a common pricing mechanism, there are significant differences in stumpage values between British Columbia and the United States (federal timber lands), as was shown earlier in Table 3.3 and Table 3.4. There are three basic sets of factors which account for these differences. The first set we have discussed already. Structural factors – such as distance from markets, differences in species mix, and harvesting costs – account for a significant portion of the differences observed in Table 3.3, Panel A (between regions in Canada and the United States), and in Table 3.4 (among various regions of the United States). One of the desirable attributes of the stumpage formula is precisely that it is so sensitive to these structural factors.

The second factor that complicates stumpage comparisons is that often stumpage bids over federal timber contracts in the United States are erroneously compared with stumpage prices in British Columbia. In British Columbia, currently prevailing end-product prices enter the stumpage calculation and stumpage values reflect the current market valuation of timber. However, in the United States, the Pacific Northwest for example, the process is more complex. The appraised value of timber from the Rothery formula, which would be comparable to British Columbia stumpage values, merely sets the minimum bid or "upset" price which the U.S. Forest Service will accept for the right to harvest timber from federal government land. This first step would be based on current end-product prices. The rights to harvest the allowable cut are allocated on the basis of competitive bidding, with the individual or firm offering the highest bid receiving the federal timber contract. The winning bid ensures the right to harvest timber, usually anywhere from one to five years in the future. Stumpage is paid as the timber is harvested. Thus, the winning bids often include an allowance for inflation and for movement in relative timber prices. Any comparison between bid prices in the United States and stumpage prices in British Columbia will, during periods of inflation, exaggerate the magnitude of stumpage differences.

The problem is that one is comparing the current market value of timber (in the case of British Columbia) with the value of timber anticipated in the future (the U.S. case). In some cases expectations regarding future timber prices may not be realized, and firms will be saddled with obligations to harvest timber whose current value is much less than anticipated years earlier when federal harvest rights had been successfully bid for.

Even comparisons between stumpage revenues actually paid to the U.S. Forest Service at the time of harvesting and stumpage values in British Columbia will often be misleading. If the expectations of the winning bidder turn out to be incorrect when harvesting is undertaken, then the stumpage payment will not reflect the prevailing market value of timber.

During the late 1970s many bids for federal timber contracts in the United States were based on the expectation that inflation would continue at the same pace into the 1980s. In reality, the rapid rise in real interest rates – to historic levels – led to a sharp fall in housing starts and a slump in demand for lumber. Timber prices fell, and many firms holding federal timber contracts would have gone bankrupt had they been forced to fulfil their contractual obligations. The U.S. Congress passed legislation that permitted firms holding federal timber contacts to break their contracts in exchange for payment of a buy-out charge (Federal Timber Contract Modification Act, Pub. L. No. 98-478, 98 Stat. 2213, 1984). This legislation bailed out firms that had gambled on continually rising timber prices and lost. Thus, cross-border stumpage comparisons can be misleading because those for British Columbia are derived from *prevailing* end-product prices while those under U.S. federal timber contracts are based on *anticipated* end-product prices.

The third set of factors that account for differences in stumpage values between British Columbia and the United States is institutional in nature. The U.S. Forest Service pursues a very restrictive form of sustained-yield management (non-declining even flow), which leads to a much smaller supply of timber available for harvesting than is true for British Columbia, where the forest service is more responsive to economic factors when setting annual allowable cuts. The issue is how quickly one depletes the stock of old-growth, large-volume timber as one comes to rely increasingly on second-growth timber. The British Columbia Forest Service is willing to allow the annual allowable cut to decline until it converges with the level of sustained yield chosen under management practices. The U.S. Forest Service is much more reluctant to permit any significant "fall-down" in allowable cut as the transition to second-growth timber is achieved.

Economists have long criticized government forest services, including British Columbia's, for releasing timber at too slow a rate relative to the economically efficient flow (Clawson 1983, 82; Percy 1986, 20-25). However, the U.S. Forest Service comes under particular criticism in this regard. For example, Clawson (1983, 82) notes:

> The Forest Service has been widely criticized by the forest products industry, by some conservationists, by many economists, by some of the western states, and by others for its very slow rate of harvesting old-growth timber. Their criticism is based on several conditions: a slow harvest means great loss of timber volume from mortality; high investment in standing timber and an associated low rate of return; low or even negative rates of net timber growth, which would be possible by new second-growth timber; and it unavoidably puts pressures on private timber, actually contributing to community instability rather than preventing it.

These costs are borne by society in the form of not fully realizing the market value of an economic asset, the forest base.

A further consequence of U.S. Forest Service policy is that it puts upward pressure on timber prices by restricting supply. John Crowell, the former assistant secretary of agriculture for natural resources and environment, stated: "It's largely because of the failure of the national forests to offer for sale more of its standing inventory that we've left a gap for Canadian timber to fill in large volumes" (Popovich 1985, 345). Significant withdrawals of timber for wilderness and wildlife exacerbate the pressure on stumpage values. The timber-supply decisions of the U.S. Forest Service put greatest upward pressure on stumpage in those areas where federal lands are most important – the Rocky Mountain and Pacific Coast regions. In 1977, the U.S. federal government owned 66.1 per cent of the commercial timber land of the Rocky Mountain region and 51.1 per cent in the Pacific Coast region (U.S. Dept. of Agriculture 1982, 121). These are precisely the regions whose politicians and industry spokesmen have been among the most vocal in calling for restrictions on Canadian softwood lumber imports.

There are other institutional differences which affect stumpage comparisons between British Columbia Crown lands and U.S. federal lands. Licence-holders of harvest rights in British Columbia assume a greater degree of management responsibility than do their counterparts in the United States. The reason for this is that licence-holders in British Columbia have longer term rights to the forest base

(area-based tenures) or to an annual allowable cut (volume-based tenures) and therefore are expected to bear greater responsibility for forest management than are firms bidding for timber harvest rights from federal lands in the United States. The greater management responsibility of British Columbia firms is reflected in higher costs and therefore leads to lower stumpage values.

Perhaps one of the most important institutional factors leading to lower stumpage values in British Columbia is the high cost of meeting close utilization standards. Utilization standards refer to the amount of material, such as stumps and crowns, that can be left behind after a site is harvested. These standards are an effort to ensure that merchantable timber (defined in terms of diameter) is not left as residue. Much of the material removed in order to satisfy these standards has little economic value, but the provincial government nonetheless still assesses it at the average stumpage rate. A study by Uhler and Morrison (1986, 1) found that meeting close utilization standards applicable to a coastal logging site reduced the value of stumpage obtained by 80 per cent. That is, the actual value of stumpage was only 20 per cent of the value that would prevail (for a much smaller volume of higher quality timber) were an economic utilization standard applied. In the U.S. Pacific Northwest, the costs of meeting utilization standards are much less because firms are not charged the average stumpage rate for removing non-economic forest material.

Thus a range of factors – structural, temporal, and institutional – complicate comparisons between British Columbia and the United States. Moreover, unadjusted cross-border comparisons divert attention from the critical questions regarding Crown timber-pricing policies and their impact on the volume of trade in softwood lumber. Does the province of British Columbia capture all of the returns to the forest base, and, if not, does it lead to injury to U.S. softwood lumber producers?

Is British Columbia Stumpage "Underpriced"?

There is no easy answer to the question whether the British Columbia government captures all of the returns to the forest base that it should. It is as much a political problem as it is an economic one. The complexity of the issues involved in pricing of Crown resources and the trade-offs between economic and social objectives are discussed in Gunton and Richards (1987). The available evidence does suggest that, if "underpricing" of standing timber does exist, it is certainly not as great as alleged by the U.S. forest industry and is probably a factor only in the Interior.

There are two aspects to the problem. The first is whether the full economic potential of the forest base is being realized. The economic answer here is emphatically no. The use by the Crown of biological rather than economic criteria to determine the level of sustained yield from the forest base, the restrictions on the export of logs, the current enforcement of close utilization standards unrelated to economic utilization levels, and a range of other institutional factors all lead to lower returns to the forest base, or less economic rent from the resource, than could otherwise be realized. However, these are "potential" returns that policy-makers have chosen not to realize because of social objectives or institutional restraints; they are not expressly the issue in the Softwood Lumber dispute, although the sovereign right of governments to make such choices is related. The full economic potential of the forest base is not being realized because some potential rents are dissipated and not captured by anyone in society.

The second facet of the problem is whether the province captures all of the returns to the forest base that the current institutional framework permits to be realized. That is, accepting that the log export embargo, the focus on sustained-yield policies, and the specification of close utilization standards, for example, may depress the value of stumpage, does the province capture the rents that do remain? Here the evidence is mixed. Copithorne (1979) argues that the province failed to capture some of the return to the forest base and that a portion of it ended up accruing to labour in the form of higher wages, especially in sawmilling. However, the data are equally consistent with increases in the wages of wood products employees resulting from higher productivity levels and higher risk premiums related to greater employment uncertainty (Percy 1986, 36-38). Moreover, if the Copithorne hypothesis were correct, it would imply that wood production, including softwood lumber, would be lower than if all the rents were captured by government. Higher wages *unrelated* to productivity considerations would increase production costs, reduce lumber production, and shift inward the extensive margin of timber harvesting. It is possible that rents captured by the forest industry could be dissipated in excess capacity built to justify higher annual allowable cuts.

It has been argued that prices on the Vancouver log exchange are too low (Pearse 1976, vol. 1, 308; Copithorne 1979, 59-60). The market for logs is relatively thin, and it is claimed that firms engage in non-arms-length transfers, using low log prices to transfer profits upstream to the wood products industry. Low prices on the Vancouver log exchange would lead to low stumpage prices for the Coast region. This hypothesis has not been tested directly. However, the evidence of Constantino (1985) does suggest that quality mix accounts for much of

the observed difference between average sawlog prices in the Coast region of British Columbia and those in the Pacific Northwest.

Recent press reports (*Vancouver Sun* 1986a) suggest that the province may not have been capturing all of the available returns in the Interior, where processing costs are included in the calculation of stumpage. There have been hundreds of millions of dollars of new investment in Interior mills since 1980, and this has led to significant improvement in lumber recovery rates and a reduction in, or at least a slowdown in the growth of, processing costs. Failure to incorporate in calculations the most recent lumber recovery estimates and cost data would lead to an underestimate of the volume of timber converted to end-products and an overestimate of the cost of doing so. Both factors would lead to stumpage values lower than warranted. Also, the chip prices used in the formula are set at an artificially low level, and so the formula undervalues the timber harvested from Crown land.

This problem is easily remedied, however, by ensuring that the most recent wood recovery and cost data are employed in the stumpage calculation. The British Columbia Ministry of Forests and Lands (1987) made precisely this recommendation in its recent Forest Management Review. Valuing wood chips at prevailing market prices would also increase stumpage values.

The real indictment of the whole process involved in the Softwood Lumber dispute is that it has failed to address the issue of whether the stumpage formula captures the full returns to the forest base. The imposition of a 15 per cent countervail duty by the U.S. or a 15 per cent export tax by Canada is an excessively blunt instrument to use to correct passive or discretionary application of stumpage regulations. It is not the formula that is at fault; it is the data used in the calculation that require attention. The public and the media have been distracted by cross-border stumpage comparisons or by dwelling on the politics of the dispute both within Canada and within the United States. The basic economic issues in the dispute – the role of market forces versus timber-pricing policies in the provinces – have not been given the proper attention.

A recent, albeit very crude, effort to calculate the share of available returns to the forest base actually captured by the British Columbia government found that, at least for 1979, the Crown was reasonably successful (Percy 1986, 38-40). If the logging industry alone is examined, the value of stumpage, fees and royalties collected by the provincial government ranged from 60.9 to 67.4 per cent of the available returns to the forest base, depending on the wage rate chosen for labour in logging. Percy (1986, 40) views these estimates of the share of the return to the forest base captured by the government to be on the conservative side. A number of biases – both in the data and in the calculations – lead to an overestimate of the returns to the

forest base that the province, as owner, should capture. Thus the estimates that are provided are in the nature of lower-bound values of the returns actually captured; the true share captured is probably higher than estimated by Percy.

The evidence on financial profitability does not suggest that the forest products industry is capturing any of the returns to the forest base that escape the Crown. The industry has a history of chronic unprofitability. A Canadian government review of the forest products sector (Canada 1978, 147-48) and Pearse (1980, 29) both note the poor financial performance of the forest products industry in comparison with manufacturing industries in Canada. In 1985, for example, selected major forest products companies had after-tax earnings of 4.3 per cent relative to shareholders' equity, while the average for all industries in Canada was 9.8 per cent. In 1984 the selected forest products firms earned -0.6 per cent on shareholders' equity after tax, while the average for all Canadian industries was 9.9 per cent (Price Waterhouse 1986, Table 3). The performance of Canadian forest firms is poor relative to their U.S. counterparts as well, as Table 3.5 illustrates. Only in the years 1978 to 1980 has the performance of the Canadian forest product firms exceeded that of the U.S. ones.

British Columbia's Stumpage Values and Injury to U.S. Producers

While there may be a failure by the provincial government to capture all of the returns to the forest base—through "underpriced" timber—the link between this and injury to U.S. softwood lumber producers is not at all clear cut. To establish injury to U.S. producers, it would have to be shown that "underpriced" timber gave Canadian producers an unfair advantage which allowed them to expand their exports, and hence their production, at the expense of U.S. producers.

The British Columbia Forest Service determines the annual allowable cut that it permits firms to harvest under various forms of tenure. In many cases the allocation of harvest rights is contingent upon satisfying management responsibilities and upon ensuring that the actual harvest, over a five-year period, is within 10 per cent of the annual allowable cut. A variation of up to 50 per cent is allowed in any one year provided the tenure-holder meets the five-year constraint. Effectively, the Crown determines the supply of timber available for harvesting and it does so independently of the level of prevailing stumpage prices.

The critical factor in assessing whether "underpricing" of timber leads to an expansion of softwood production and possible injury to U.S. softwood lumber producers is whether the harvest constraint imposed by the Crown is binding on firms. If the constraint on annual

Table 3.5
Profitability of Forest Products Companies, Canada and the United States, 1973-1985
(after-tax earnings as percentage of shareholders' equity)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Canada[a]	18.7	11.7	1.7	8.7	11.0	19.5	23.4	14.8	0.9	-11.5	-0.3	-0.6	4.3
United States[b]	22.7	17.5	10.9	14.3	14.9	17.6	17.6	11.1	8.3	4.1	5.6	6.6	6.9

Source: Price Waterhouse, "Profitability of Selected Canadian and United States Forest Products Companies," Memorandums of Canadian Forest Industries Council concerning the Alleged Stumpage Subsidies, September 8, 1986.

Notes: a. Companies included: Balco Industries, British Columbia Forest Products, Crestbrook Forest Industries, Crown Forest Industries, Doman Industries, Gregory Industries, MacMillan Bloedel, Normick Perron, Weldwood, Whonnock Industries.

b. Companies included: Bohemia, Boise Cascade, Georgia-Pacific, Louisiana-Pacific, Pope and Talbot, Potlatch, Weyerhaeuser, Williamette Industries.

allowable cut is binding, all that firms can do if the Crown fails to capture all the returns to the forest base is pocket the difference between the true market price of timber and the price charged by the Crown. This difference would show up as an increase in profits to the firm and industry. Producers in the United States would not be harmed as a consequence of this "underpricing." Conversely, if the market for lumber is depressed and firms are required to harvest their quota regardless of the market price, they would incur losses.

If Canadian softwood lumber firms were not profit maximizers but were motivated by, perhaps, the volume of sales, then the capture of rent might influence production and export volumes. Yet to adopt a non-profit-maximizing paradigm to explain firm behaviour is a strong assumption. Moreover, market forces have the potential for driving sales-maximizing management out of authority. It would always pay financially for a profit-maximizing firm to buy out a sales-maximizing firm, replace the management, and run it on a profit-maximizing basis.

The case where the annual allowable cut is not a binding constraint on the harvesting decision of firms could lead to injury to U.S. firms if timber is "underpriced." Firms would respond to a stumpage charge lower than the market value of timber by expanding timber harvesting and increasing the output of wood products and pulp and paper products. Under this scenario, softwood lumber exports to the United States could increase and U.S. producers, paying the market value of stumpage, would find it difficult to compete.

It is difficult to say with any degree of certainty whether the annual allowable cut allocation is a binding constraint on firms in British Columbia. Evidence provided by Heaps (1987) for the Coast region does suggest that the annual allowable cut set by the government was in line with desired harvest levels of firms during the 1970s, but in the 1960s the allowable cut was found to be a binding constraint. That is, the allowable cut might not have been a binding constraint on firms in the 1970s.

There are factors that are likely to make the timber-supply constraint binding on many tenure holders. For many firms it is a condition of their tenure that their actual harvest rate does converge on the allowable cut set by the chief forester of the province, although passive enforcement of the regulations could mitigate this constraint somewhat. However, the allowable cut consistent with sustained-yield management is based on timber inventory data that define the physical availability of timber. The volume of timber that is economically accessible may be significantly lower than that which is physically available. For example, a recent study for the British Columbia Coast region found that under current economic conditions only 26 per cent of the timber inventory was economically accessible

(Williams and Gasson 1986). Limits on the economically accessible timber supply, combined with any degree of stringency in the enforcement of annual allowable levels by the Crown, would make it highly likely that the timber supply would be a binding constraint on firms.

One further bit of evidence that perhaps the timber constraint is binding *and* that the province may not capture all the returns to the forest base comes from merger activity in the forest industry. It has been observed that some forest industry firms command a price in mergers or sales apparently well in excess of the value of the capital stock or any customer goodwill they possess (Bernsohn 1981, 5-8). An explanation for this phenomenon is that the firms possess rights to timber allocation or "quota" and capture some of the returns that should accrue to the Crown. Thus, bids for such firms include a premium reflecting the capitalization of these quota rents. For this possibility to exist two conditions must obtain: the timber-supply constraint must be binding and stumpage must be underpriced. If the constraint is not binding there are not rents, or returns to the forest base, to capitalize as part of the value of the firm. Under these circumstances the failure of the Crown to capture all of the rents would *not* lead to injury to U.S. producers.

Had the Softwood Lumber dispute gone the full course – after a predictably negative final determination by the ITC on December 30, 1986, going on to the ITC for a final determination of injury – it is possible, but not likely, that Canada might have escaped the imposition of countervailing duties. The ITC could have accepted the ITA determination of subsidy but found no injury to U.S. producers. This outcome would have required the ITC to accept the notion that, under some circumstances, the distribution of resource revenues between the Crown and firms has no impact on production levels. The United States Federal Trade Commission made precisely these arguments when appearing before the ITC in both the 1983 and the 1986 Softwood Lumber cases. However, the political climate in the United States, combined with the relatively low level of economic sophistication displayed by the ITC (at least in the Softwood Lumber dispute), made an outcome in Canada's favour highly improbable.

Notes

1. The intent of the specificity requirement is to identify subsidies that distort a country's comparative advantage. The presumption is that generally available subsidies would not do so.

2. The preliminary determination notes "petitioner alleged that in Alberta the government provides forest management agreements only to users who agree to process all standing timber of suitable size in a sawmill and then to use the residues and remaining trees for pulp. . . . In British Columbia, petitioners alleged that the government may limit applicants to specific industries. Petitioner cites two sales in the Queen Charlotte Timber Supply Area which required the successful applicants to operate sawmills on Graham Island" (U.S. Dept. of Commerce 1986, 15-16). However, these examples clearly related more to the inherent characteristics of timber than to targeting. There is just no alternative use for timber other than that required in the documents.

Chapter 4:

The Legal Context of the Softwood Lumber Dispute

The foregoing analysis was of the economic arguments that can be made in the Softwood Lumber dispute. It suggested that market factors, unrelated to the exercise of governmental discretion in administering stumpage fees, are more explanatory of Canadian inroads into U.S. markets than are alleged subsidized stumpage practices. The economic analysis also demonstrated that the issues in the dispute were not being considered on the basis of sound economic principles. This chapter discusses the legal context of the dispute. It identifies the anatomy of the coercive mechanism whereby Canadian softwood producers have been forced to submit to a 15 per cent export tax and highlights its implications. With respect to the legal dimension of the dispute, the conclusion is similar to that reached at the end of the economic analysis, namely, that the legal concepts put forward as a basis for resolving the matter were themselves stretched to such an extent, in order to reach the desired result, that the process lost any claim to legal legitimacy that it might previously have had. Principled reasoning gave way to political expediency. How and why the U.S. legal system generated this kind of result is the theme of this chapter.

Trade Powers under the U.S. Constitution

The U.S. Constitution gives Congress jurisdiction over trade and commerce. United States court decisions have given broad scope to

the trade and commerce power, which includes the power to deal with trade practices that are perceived as harmful or unfair. Congress, through trade legislation, delegates powers to deal with trade to the executive branch, including direct, decision-making involvement in specific legal remedies that have been created in response to political pressure. United States trade remedies can best be understood by keeping clearly in mind the tension between Congress and the Executive over trade powers. Congress has the power to strip the Executive of trade jurisdiction and uses this to influence executive actions. The president has a much broader constituency to play to than do specific congressmen and hence the president needs broad discretionary powers in order to be able to act in the national interest. The president's task is somehow to act for the general good without offending specific congressional coalitions. In trade matters, this can mean that he must exercise his discretion for reasons not entirely related to the merits of a specific trade dispute itself.

The president acts on trade matters primarily through his trade representative and officials in the Department of Commerce (DOC). Officials in these offices determine many important aspects of trade policies by making specific findings pursuant to quasi-judicial proceedings. The International Trade Administration (ITA), for example, being an agency within the DOC, decides whether foreign government practices are "subsidies" under U.S. countervailing-duty law. Congress influences trade policy to some extent through its appointment of commissioners to another important agency with direct powers of decision in some trade disputes, the International Trade Commission (ITC). This fact-finding body was established in 1916. Its purpose is in part to take political heat generated by foreign trade problems off Congress, giving an impartial tribunal the responsibility of bringing at least the semblance of objective, dispassionate fairness to the resolution of trade disputes. One of the responsibilities of the ITC is to decide if subsidies (as found by the ITA) are injuring domestic producers.

Specific trade remedies are crafted in response to, and can only be understood in light of, this division of powers between Congress and the Executive. In some cases, Congress has given the president responsibility to exercise his discretion directly within the context of a trade remedy. Section 201 of the Trade Act of 1974, for example, is often referred to as the "Escape Clause remedy." Under it the ITC makes a finding as to whether the domestic industry has been seriously injured by imports. If it finds that it has, recommendations are made as to what the president should do. But the president (subject to congressional override) is given broad discretion as to what remedy, if any, will actually be implemented. Section 301 is like Section 201 in that it gives the president discretion to deal with trade

problems, particularly the power to enforce U.S. rights under international trade agreements.

Remedies that are meant to give the president broad discretion are to be contrasted with those that give him no discretion and which instead give petitioners what amounts to private legal rights. The countervail and antidumping remedies are prime examples of the latter kind of trade remedy. The ITA and ITC are given final decision-making roles in the deliberations making use of these remedies. The petitioners are guaranteed results that are immune from broader political pressure if they can prove their case satisfactorily before these quasi-judicial agencies.

For a beleaguered U.S. industry, the choice of which remedy to pursue is a complex one involving consideration of a variety of factors. In the case of the Softwood Lumber decision, the countervailing remedy was selected for use, probably because, initially at least, the group of complainants was relatively small (lack of broad political support) and the perception of "unfair" subsidization was perhaps present in the minds of the petitioners as a visible, at least *prima facie*, irritant. It is interesting to note that in the Wood Shakes and Shingles decision (Wood Shakes and Shingles TA-201-56) the 201 remedy was used, with the president (at the time being in trouble with Congress over trade) ultimately deciding to use his discretion to apply the tariffs as recommended by the ITC. In the Softwood Lumber case, the ultimate fate of the contestants lies outside of presidential discretion, in the findings of the ITC and ITA. Ironically, though the intergovernmental agreement, which was negotiated because of the assumption that the ITA's final ruling would impose a high tariff against Canada and which has temporarily suspended the legal aspect of the dispute, involved the executive branch in a discretionary role.

The Legal Context of the 1982-1983 Phase of the Lumber Dispute

The operative legal concept underlying the 1982-1983 phase of the Lumber dispute was the general rule stated in the Tariff Act of 1930, as amended by the Trade Agreements Act of 1979 (in particular paragraphs 1671-1677g), that subsidized imports are countervailable. This rule is stated twice in U.S. legislation. The earlier expression of it, found in Section 1303 of the Tariff Act of 1930, is that whenever a "bounty or grant" is bestowed upon an imported article, a countervailing duty must be imposed to offset its effect. This formulation of the rule does not require measurement of the injury effect of the imports and is only to be applied to countries who are not party to the GATT Subsidies Code. A second enunciation of the rule was put forth in the Trade Agreements Act of 1979, which

implemented the GATT Subsidies Code.[1] Canada is a party to the Subsidies Code, and the Lumber dispute was governed by this second formulation of the rule, which refers to "subsidy" as well as to "bounty or grant" and which does require an injury test:

> 1671. Countervailing duties imposed
>
> (a) General rule. If–
>
> (1) the administering authority determines that–
>
> (A) a country under the Agreement, or
>
> (B) a person who is a citizen or national of such country, or a corporation, association, or other organization organized in such a country,
>
> is providing, directly or indirectly, a subsidy with respect to the manufacture, production, or exportation of a class or kind of merchandise imported into the United States, and
>
> (2) the Commission determines that–
>
> (A) an industry in the United States–
>
> (i) is materially injured, or
>
> (ii) is threatened with material injury, or
>
> (B) the establishment of an industry in the United States is materially retarded,
>
> by reason of imports of that merchandise,
>
> then there shall be imposed upon such merchandise a countervailing duty, in addition to any other duty imposed, equal to the amount of the net subsidy.

Under this statute the ITA must determine if a country is providing a subsidy and the ITC must determine whether imports of the subsidized product are causing or threatening to cause material injury to a U.S. industry. If both findings are positive, a countervailing duty must be imposed.

The interplay between the procedural timetables of the two agencies is as follows. After a petition is filed, the ITA has 20 days to decide whether it will initiate an inquiry. If the ITA decides to go ahead with an inquiry, the ITC must begin its injury investigation and render its preliminary finding within 45 days of the date on which the petition is filed. The ITA makes its preliminary findings as to the existence of a subsidy within either 85 or 150 days of the date on

which the petition is filed. If it is an affirmative determination, the ITC must resume its injury investigation. The ITA has 75 days after issuing its preliminary finding in which to fender its final determination. If this determination is positive, the ITC must make its final injury determination within 45 days. The entire process has a maximum length of 270 days.

A respondent to a countervailing petition may submit information to and appear before both administrative agencies over the remedies' procedural course. The ITA's findings are somewhat more normative in nature than are those of the ITC. The ITA must ultimately characterize programs from the standpoint of whether or not they are "fair". (It is widely accepted in trade law doctrine that certain subsidies are "unfair" trade practices.) The ITC, on the other hand, is given a less subjective task. It is to determine if an industry has been injured. It has, of course, discretion in deciding which facts to use and how much weight to give the facts it chooses, but its final determinations are more capable of being referred to as "objective" than are the ITA's. In this chapter the focus will be on the ITA's function in the subsidy-determination process. Unless a program is found by the ITA to be a countervailable subsidy, the injury question has no relevance.

The statement of the subsidy-countervail rule in the Trade Agreements Act of 1979 is accompanied by a definition of "subsidy." The definition was put in partly to reflect the DOC's interpretation of "bounty or grant" as it had developed over the years. It did not, therefore, mark a departure from previous practice. However, it did, provide an explicit and detailed (though not exhaustive) list of practices by which impugned programs are to be measured. It illustrates the tendency of legislation to become more detailed as public pressure for congressional action increases. Here is the definition:

> 1677(5) Subsidy – The term "subsidy" has the same meaning as the term "bounty or grant" as that term is used in section 1303 of this title, and includes, but is not limited to, the following:
>
> (A) Any export subsidy described in Annex A to the Agreement (relating to illustrative list of export subsidies).
>
> (B) The following domestic subsidies, if provided or required by government action to a specific enterprise or industry, or group of enterprises or industries, whether publicly or privately owned, and whether paid or bestowed directly or

indirectly on the manufacture, production, or export of any class or kind of merchandise:

(i) The provision of capital, loans or loan guarantees on terms inconsistent with commercial considerations.

(ii) The provision of goods or services at preferential rates.

(iii) The grant of funds or forgiveness of debt to cover operating losses sustained by a specific industry.

(iv) The assumption of any costs or expenses of manufacture, production, or distribution.

This definition refers to two types of subsidies: export and domestic. It was paragraph 1677(5)(B)'s definition of countervailable domestic subsidies that was applied by the ITA to British Columbia's stumpage practices of British Columbia, Alberta, Ontario, and Quebec.

The word *specific* appears in paragraph 1677(5)(B), modifying "enterprise or industry, or group of enterprises or industries." The ITA has given special importance to the meaning of this phrase, a practice which has resulted in there being frequent reference to "the specificity test." If a subsidy is not specifically bestowed, it is often referred to by the ITA as being "generally available." Thus, there is also frequent reference to the "general availability test." The idea that a countervailable subsidy must be one that is specifically bestowed is rooted in market ideology. If a particular entity is spared the rigours of the market it has been subsidized and, under U.S. countervail laws, competitors of the subsidized entity have the right to have the comparative advantage of the subsidy eliminated by the imposition of countervailing duties.

Just prior to the 1982-1983 Lumber case proceedings, the U.S. Court of International Trade handed down a decision, *Carlise Tire and Rubber Co.* v. *U.S.*, in which the dimensions of this specificity test of paragraph 1677(5)(B) were discussed and its application by the ITA affirmed. The court, in this decision, was considering whether a Korean tax deduction for accelerated depreciation which was generally available was a countervailable domestic subsidy. The court decided that it was not and in doing so emphasized the specificity aspect.

> In the case of domestic subsidies the ITA has here interpreted "bounty or grant" as connoting some special or comparative advantage conferred upon an industry or

> group of industries and not available to all manufacturers and producers within a given country. Absent an industry-specific or regional preference, the ITA contends, there can be no bounty or grant as the term is used in section 303.
>
> The court agrees with the ITA's interpretation of section 303. (564 F. Supp. 1983, 837-38)

The court emphasized that the new term "subsidy" added by the Trade Agreements Act of 1979 was meant to give the words "bounty" or "grant" the same meaning which administrative practice and the courts had given it previously.

> Significantly, section 771(5) lists several examples of domestic subsidies which are countervailable, but conditions these examples with the proviso that they be furnished *to a specific enterprise or industry, or group of enterprises or industries*. (564 F. Supp. 1983, 839, emphasis added)

Implicit in the idea of specificity is the view that it denotes preference. If only certain members of the business community receive the benefit of the government action, it is presumed to be reasonable at least to investigate whether they have been given a preference over a broader community. This choosing and applying preferential benchmarks is a second aspect of determining the existence of subsidies. The process requires identification of market factors that a firm would face in the absence of the government's actions. If a program is selectively bestowed, and if this bestowal results in a measurable preference being given, the program is a countervailable subsidy.

This was the legal conceptual backdrop heading into the first round of the Lumber dispute. The ITA, in administering the Lumber dispute, looked at the alleged domestic subsidies from the standpoint of whether they were specific to an industry or a region and, if so, whether they bestowed a preferential benefit.

The Specificity Test

Application to Stumpage Practices

In the 1982-1983 phase of the Lumber dispute, the ITA disposed of the argument that stumpage practices constituted export (as opposed to countervailable domestic) subsidies in one short paragraph.

> First, stumpage programs do not confer an export subsidy because they do not operate and are not intended to stimulate export rather than domestic sales, and because they are not offered contingent upon export performance. The mere fact that significant quantities of products made from stumpage are exported to the U.S. does not mean that stumpage programs confer an export subsidy. (48 Fed.Reg., May 31, 1983, 24159 at 24167)

The ITA then disposed of the argument that the stumpage practices were countervailable domestic subsidies. The petitioner had argued that stumpage practices offended the specificity condition of subsection 1677(5) and fell under subparagraph 1677(5)(B)(iv):

> The assumption of any costs or expenses of manufacture, production, or distribution.

The ITA rejected this argument, stating that preferentiality was the correct standard. The ITA noted the distinction between a program that was generally available to any applicant, with the only limitation upon its use arising from the nature of the resource itself, and a generally available program which was by government action restricted only to a specific industry such as, for example, the lumber industry. Stumpage programs were viewed as broad; any possible limitations on their use were due only to the inherent characteristics of the timber resource and the current level of technology, not to government interference.[2]

The ITA went on, however, to say that even if the stumpage programs were tainted with specificity, they would not be countervailable because they did not provide goods at preferential rates within the meaning of 1677(5)(B)(ii), which reads: "The provision of goods or services at preferential rates."

The ITA admitted that subparagraphs (i) to (iv) were not an all-inclusive list of domestic subsidies but held that it was necessary to fit an impugned program into whichever of the four options it best fitted; in doing this the four categories were to be viewed as mutually exclusive. The ITA refused to consider the petitioners' argument that stumpage programs were the "assumption of any costs or expenses" under subparagraph (iv). They held that stumpage programs clearly involved the provision of a good (raw timber) and therefore fell within subparagraph (ii).

The ITA also pointed out that preferential did not mean "inconsistent with commercial considerations," a term used in subparagraph 1677(5)(B)(i). "Preferential" in subparagraph (ii) was viewed as having its normal meaning of favourable treatment of some

applicants with respect to others within the same jurisdiction, a meaning which the ITA determined had no application to stumpage practices. The argument that stumpage programs comprised countervailable domestic subsidies was rejected on the basis that the programs were not, by government action or in practice, restricted to specific industries and, further, that they did not constitute the provision of goods at preferential rates.

In its 1983 decision the ITA went on to say a number of interesting things about stumpage programs and subsidy definitions. Although the remarks were not crucial to its decision, they throw interesting light on how the ITA at that time viewed stumpage practices.

The ITA held that the word "assumption" in subparagraph (iv) was restricted to government activity that relieved an enterprise or industry of a pre-existing statutory or contractual obligation and could not be interpreted as applying to such things as costs of production or preferential rates as used in subparagraphs (i) to (iii). Stumpage programs obviously do not relieve companies of the kind of obligations envisioned by the ITA as coming under this subsection.

The ITA went further and said that even if "assumption" had a broad meaning and could encompass stumpage programs, it could not be concluded that the programs had effectively reduced and thereby "assumed" costs of production. The ITA rejected the argument that cross-border comparisons were appropriate to establish the commercial benchmark for North American stumpage. It pointed out that every stand of timber is unique for a variety of reasons – such as species, combination, density, quality, size, age, accessibility, and terrain and climate – and that stumpage prices vary regionally and locally within the United States and Canada. Interestingly, the ITA observed that, even if U.S. prices were used as a benchmark, there was evidence which established that the Canadian governments do not assume costs of production through their stumpage programs. The ITA specifically opined that the approach based on residual value, such as the approach used by British Columbia to set stumpage rates, was a reasonable method for establishing stumpage prices and could "not be said to not reflect true market value" (48 Fed. Reg. 24168).

The wording of paragraph 1677(5)(B) requires the ITA to determine both if a given program fits under any of the four categories (i) to (iv) *and* whether it is, in addition, made available to a specific industry. On either test, stumpage programs were not classified as countervailable subsidies. Specificity was tied to governmental action that limited a program's availability. British Columbia stumpage policies passed the test in 1983 and have not been changed since. The U.S. law, however, came under mounting pressure before the hearing

of the second round of the Lumber dispute, as further considerations of the legal context will illustrate.[3]

Mexican Pricing Policies, Petroleum and Natural Gas

The Canadian Lumber case of 1982-1983 provided a good test for the definition of subsidy under U.S. legislation. The case demanded careful consideration of a broad range of programs (including many not related to stumpage) and illustrated the difficulty of applying a general, legislated definition of subsidy to the natural resource practices of a foreign country. Specific government activities are difficult to stigmatize as illegal by using general definitions. This point was borne out by decisions made subsequent to the Canadian Lumber decision with respect to Mexican natural gas pricing policies.

In the months immediately following the Canadian Lumber decision, the ITA handed down three rulings that were related to the resource-pricing policies of Mexico, all having to do with petroleum and natural gas. The cases are of interest because they further illustrate the ITA's application of the specificity test; and because they were for the most part decisions that went against U.S. petitioners. The results of these decisions, combined with the Canadian Lumber decision, stimulated Congress to draft more specific legislation regarding natural resource subsidies.

In the Anhydrous and Aqua Ammonia from Mexico decision (48 Fed. Reg., June 22, 1983, 28522), the ITA held that Mexico's natural gas pricing policy did not confer a bounty or grant under the Tariff Act of 1930. The petitioners argued that Mexico provided the state-owned petroleum company PEMEX with natural gas below a commercially reasonable rate. The ITA verified that PEMEX's export price for natural gas was substantially higher than the price for natural gas within Mexico but refused to rule that this conferred an export subsidy or a countervailable domestic subsidy upon the Mexican ammonia industry.

> The pricing differential does not confer a benefit contingent upon export performance, nor does it stimulate export sales of ammonia over domestic sales. Nor is it limited to a "specific enterprise or industry or group of enterprises or industries" within Mexico. (48 Fed. Reg. 28524)

The application of the specificity test in these circumstances was rather mechanical, involving consideration of whether the natural gas was available to a broad enough group of purchasers within Mexico at the same price. The ITA determined that the differential between

industrial and consumer rates within Mexico did not make the industrial price a bounty or grant; the ITA did not consider it to be a relevant factor that the price of natural gas in Mexico was much lower than its export price to U.S. consumers, since the purchase of Mexican gas at the specified price was not linked to export performance and many industries in Mexico used the gas. The decision was consistent with the Lumber decision insofar as the ITA refused to consider cross-border price comparisons to establish the commercial benchmark for the resource.

In the Carbon Black from Mexico decision (48 Fed. Reg., June 27, 1983, 29564) certain preferential prices of petroleum products, natural gas, and electric power used to produce carbon black were found to confer a bounty or grant and were therefore countervailable. A frontal attack on the Mexican prices as compared with U.S. prices failed for the same reasons given in the Anhydrous Ammonia decision, but the ITA determined that a countervailable subsidy existed in the preferential 30 per cent discount on the national prices of petroleum feedstock and natural gas to selected enterprises, including carbon black plants located in specified regions. This time the specificity test was met. The ITA found that a specific regional enterprise was given the natural resource at a discounted price, and the availability of the discount was partially dependent on regional location as specified in Mexico's regulations. The discounted price was determined with reference to the price of the same product to other producers within Mexico and not with reference to U.S. prices. The ITA also found that a government program (FONEI) that granted long-term credit at below market rates to enterprises that located in specific regions was also a countervailable subsidy.

In the Portland Hydraulic Cement and Cement Clinker from Mexico decision (48 Fed. Reg., Sept. 21, 1983, 43063) the ITA found that certain Mexican practices were countervailable but that alleged preferential prices for petroleum products used in the production of cement were not countervailable. Again, as in the previous two decisions, the attempt to compare Mexican internal prices with U.S. prices was rejected.

The three Mexican decisions all illustrated that the specificity test was restricted to an analysis of prices within the boundaries of the state whose practices were in question and that cross-boundary price comparisons could not be made. In the Lumber decision the ITA went further than it did in the Mexican decisions and stated that even if a cross-border comparison were made, Canadian stumpage prices would not constitute subsidies. The Mexican decisions did not venture any such speculation. At this point in the development of U.S. law, the specificity test as found in paragraph 1677(5)(B) had frustrated U.S. producers who had sought to focus on the natural resource prices of

both Canada and Mexico. Subsequent judicial interpretation of the specificity test muddied the conceptual waters by suggesting that the ITA might be construing the test too narrowly.

Judicial Attack on the ITA's Interpretation

On June 8, 1984, the U.S. Court of International Trade handed down its decision in *Bethlehem Steel Corp.* v. *U.S.* (590 F. Supp. 1984, 1237). In this decision the court upheld an ITA ruling that an income tax deduction allowed for the expenses of employee training programs was not a bounty or grant, i.e., not a countervailable domestic subsidy. Yet in doing so the court digressed to a significant extent and criticized, in dicta, the specificity concept as it had been developed by the ITA. The court attacked the notion that a program could not be subsidy simply because it was generally available:

> Can it be argued that financial assistance which is inconsistent with commercial considerations is no longer a subsidy when it is part of the basic policy of a government and available to all business? (590 F. Supp. 1984, 1242)

The court acknowledged that past cases involved subsidies that were selectively bestowed, "but it was the element of *benefit* not the element of selectivity, which made them subsidies." (590 F. Supp. 1984, 1243). This reasoning suggests that certain practices by governments which bestow commercial benefits and which are generally available may, nevertheless, be characterized as countervailable domestic subsidies. Such subsidies are distinguishable from ones which merely relieve a specific group from an adverse governmentally imposed limitation. The court drew the line this way:

> In more abstract terms, those acts of a government which are fundamentally adverse to the purely economic self-interest of business enterprises are not subsidies. Decisions to reduce or eliminate the adverse effects of those acts are simply forms of a decision as to the desired extent of the adverse effect. The level of adverse effect is transformed into a positive benefit only when a select group is freed from the adverse effect while others are not. That is an act of subsidy by means of selective relief from an adverse condition.
>
> Such acts are distinguishable from acts which are donative or beneficial in their nature, by means of positive displays of largesse in the first instance. The size of the class of beneficiaries has no logical part in deciding whether

intrinsically beneficial acts are giving benefits. The benefit of an original beneficial act is self-evident.

The only place for a test of "general availability" is in the determination whether a practice which is normally not a subsidy, but merely a decision as to the level of an adverse effect, has been transformed into a subsidy by means of selective application. The practice of allowing deductions from taxable income is a decision regarding the level of taxation. It is a practice which is not a subsidy unless it is done selectively.

But laws or acts which give benefits by means other than the contraction of the exercise of governmental powers, that is to say, by positive beneficial acts cannot be judged by the same logical standard. If such benefits are by some chance, generally available, that alone does not provide assurance that they are not subsidies. With respect to benefits the development of exceptions should await the clarifying effect of individual cases. (590 F. Supp. 1984, 1245)

The court did not spell out by way of example what a benefit conferring generally available subsidy might look like. Are British Columbia's stumpage programs in this category? By what factors of commercial fairness should an impugned program be measured?

The Trade and Tariff Act of 1984

On October 30, 1984, Congress, responding in part to pressure from those interest groups that had been frustrated in attempts to impose countervailing duties on Mexican natural-resource-based commodities, passed the Trade and Tariff Act of 1984. The act added to the definition of subsidy under subsection 1677(5) a new term – "upstream subsidies":

1677.1. Upstream subsidies

(a) Definition. – The term "upstream subsidy" means any subsidy described in section 1677(5)(B)(i), (ii), or (iii) of this title by the government of a country that –

(1) is paid or bestowed by that government with respect to a product (hereafter referred to as an "input product") that is used in the manufacture or production in that country of merchandise which is the subject of a countervailing duty proceeding;

(2) in the judgment of the administering authority bestows a competitive benefit on the merchandise; and

(3) has a significant effect on the cost of manufacturing or producing the merchandise.

In applying this subsection, an association of two or more foreign countries, political subdivisions, dependent territories, or possession of foreign countries organized into a customs union outside the United States shall be treated as being a country if the subsidy is provided by the customs union.

(b) Determination of competitive benefit –

(1) In general. – Except as provided in paragraph (2), the administering authority shall decide that a competitive benefit has been bestowed when the price for the input produce referred to in subsection (a)(1) of this section for such use is lower than the price that the manufacturer or producer of merchandise which is the subject of a countervailing duty proceeding would otherwise pay for the product in obtaining it from another seller in an arms-length transaction.

(2) Adjustments. – If the administering authority has determined in a previous proceeding that a subsidy is paid or bestowed on the input product that is used for comparison under paragraph (1), the administering authority may (A) where appropriate, adjust the price that the manufacturer or producer of merchandise which is the subject of such proceeding would otherwise pay for the product to reflect the effects of the subsidy, or (B) select in lieu of that price a price from another source.

(c) Inclusion of amount of subsidy. – If the administering authority decides, during the course of a countervailing duty proceeding that an upstream subsidy is being or has been paid or bestowed regarding the merchandise under investigation, the administering authority shall include in the amount of any countervailing duty imposed on the merchandise an amount equal to the amount of the competitive benefit referred to in subparagraph (1)(b), except that in no event shall the amount be greater than the amount of subsidization determined with respect to the upstream product.

As discussed earlier, with minor exceptions, Mexico's two-tier pricing system for natural gas was found by the ITA to be immune

from the countervailing-duty law. Congress, in response partly to this practice, amended the law in an attempt to overcome the difficulty. The "upstream subsidy" concept was designed at least in part to get at the two-tier pricing of natural resources. It is designed to apply to "input products," such as natural gas, which are sold at prices below those that are generally available and which therefore bestow a competitive advantage on the producer of the final exported product, e.g., ammonia.

The definition states that upstream subsidies are subsidies described in 1677(5)(B)(ii) and (iii) which happen to apply to input products instead of the final exported product. This structural link to ordinary domestic subsidies means that the specificity test analysis applied by the ITA in determining the existence of ordinary domestic subsidies must also apply to upstream subsidies. An upstream subsidy is not, therefore, a new breed of subsidy. Its point of bestowal, not its conceptual make-up, distinguishes it from a regular domestic subsidy.

Proving that an upstream subsidy exists thus requires the conventional specificity-preferential analysis and then two additional considerations: whether the subsidy bestows a competitive benefit on the exported (countervailed) merchandise and whether it has had a significant effect on the cost of manufacturing it.[5] These two additional requirements make the upstream subsidies test more complex and difficult to meet than the already difficult test for ordinary domestic subsidies. Ironically, it may be in the interests of the respondent in a countervailing action to argue that the petitioner *must* use the upstream subsidies test. The Canadian respondent tried this in Live Swine and Fresh, Chilled and Frozen Pork Products of Canada (50 Fed. Reg., June 17, 1985, 25097), arguing, unfortunately unsuccessfully, that live pigs were an "input product" with respect to unprocessed pork. The ITA, however, emphasized the point that agricultural products required a different kind of analysis from industrial products, and concluded that there was a continuous line of production from live swine to unprocessed pork. It is unlikely that the upstream subsidy definition itself could transform British Columbia's stumpage practices from being non-countervailable to countervailable. The argument was apparently not raised before the ITA in the second round of the Softwood Lumber dispute.

The dynamism of the U.S. political-legal process is manifested both by the enactment of legislative definitions to meet the demands of interest groups and by the willingness of the same groups to use the court system to counteract the administrative interpretation of these definitions. This persistent tendency of various groups to render the law pragmatically useful has the effect of lessening its normative stability. A good example of this process is provided by the following

judicial decision, which, like the preceding *Bethlehem Steel* case, is an attack on the ITA's interpretation of the specificity test.

Further Judicial Attack on the Specificity Test

In *Cabot Corp.* v. *U.S.* (620 F. Supp. 1985, 722) the court heard an appeal from an ITA decision that *inter alia* determined that Mexico's natural gas pricing policies did not constitute a countervailable domestic subsidy. The ITA's decision was based on the specificity test as it had been developed up to and during the time of the first Canadian Lumber decision. In *Cabot*, the court criticized the ITA for applying the "incorrect" general availability test and sent the matter back to it for reconsideration.

> The distinction that has evaded the ITA is that not all so-called generally available benefits are alike—some are benefits accruing generally to all citizens, while others are benefits that when actually conferred accrue to specific individuals or classes. Thus, while it is true that a generalized benefit provided by government, such as national defense, education or infrastructure, is not a countervailable bounty or grant, a generally available benefit—one that may be obtained by any and all enterprises or industries—may nevertheless accrue to specific recipients. General benefits are not conferred upon any specific individuals or classes, while generally *available* benefits, when actually bestowed, may constitute specific grants conferred upon specific identifiable entities, which would be subject to countervailing duties. (620 F. Supp. 1985, 731)

The court, in this case, seemed intent on widening the specificity test that ITA had been applying over the course of several years. Under the court's statement of the rule for determining countervailable domestic subsidies, Mexico's natural gas pricing policies would probably be countervailable. Though PEMEX made the carbon black feedstock and natural gas available to all industrial users at below world market prices, the benefit of the lower prices could arguably be said to fall, in actuality, upon a specific industry. The benefit was not like the provision of tax or infrastructure benefits that would have been available and have been of actual benefit to all industries.

British Columbia's stumpage programs are theoretically available to anybody but are in fact used by only certain industrial groups. Are they, therefore, countervailable? In the second round of

the Lumber dispute the ITA specifically referred to the fact that the Cabot Corporation decision had forced it to rethink its definition of subsidy, and it found that they were.

The ITA's Preferentiality Appendix

On April 18, 1986, the ITA issued a decision pursuant to an administrative review of its Carbon Black decision of June 27, 1983. The review was made in accordance with Department of Commerce regulations. At the end of the review the ITA set forth a "Preferentiality Appendix" wherein it explained the methodology it would use to determine the issue of "preferentialness" in subsidy cases under subparagraph 1677(5)(B)(ii) – "the provision of goods or services at preferential rates." It will be remembered that it was this language about preferentiality that the ITA said in the 1983 decision was the applicable language, and which it found stumpage prices did not violate.

In determining preferentiality, the ITA is deciding if a government action gives an industry a comparative advantage. It must have, therefore, some benchmark against which to measure the industry's position in the absence of the "subsidy." In the Preferentiality Appendix, the ITA stated very strongly that it would try to avoid going outside the jurisdiction for price comparisons. The appendix established the order of priority that the ITA will give to benchmark criteria in determining subsidy issues. The ITA's first choice for such a comparative criterion is prices charged by the same seller for a similar or related good. Under this reference point the ITA would look at what the government charged for a similar good that was generally available. It is difficult to imagine how this criterion could help the ITA with stumpage practices. There is only one thing being sold. What does the government have to sell that is similar to stumpage? In the second round of the Softwood Lumber dispute the ITA mentioned that hardwood stumpage would be the only comparative reference point and dismissed the idea as not being viable.

The ITA's second choice is to compare the "subsidized" price to prices charged within the jurisdiction by other sellers, for an identical good or service. These sellers can include private sellers within the jurisdiction or foreign sellers selling into the jurisdiction. The assumption underlying this test is that in the absence of preference, the government would opt to provide the good or service at a price in line with commercial practice. The small amount of timber in private hands in British Columbia could provide a reference point for comparison in the Softwood Lumber case but because of the relatively small amount of privately owned timber in British Columbia the

value of such a comparison would be dubious. The ITA refused to make such a comparison in the second round of the dispute.

The ITA's third reference point for measuring preferentiality is to compare the "subsidized" price to the same seller's cost of producing the good or service. In its Preferentiality Appendix, the ITA had expressly stated that this criterion would probably not work with natural resources:

> There are two major shortcomings of this approach. One is that it may not be workable for certain goods, especially natural resources. (51 Fed. Reg., April 18, 1986, 13273)

Remarkably, it was this third reference point that was chosen for application in the second round of the Lumber dispute before the ITA.

The ITA's fourth, and the least desirable, comparative benchmark is that provided by external prices. The ITA feels that regardless of which external price is chosen, a domestic subsidy is no longer being defined by its effect on the domestic market. The test does not measure preference within an economy. In the second round of the dispute, the petitioners argued that such a cross-border comparison of prices was appropriate under the circumstances, but did not persuade the ITA to adopt the practice.

The appendix gives little certainty as to the approach the ITA will take with respect to deciding the issue of preferentiality. Having stated in April 1986 that the third benchmark of preferentiality was particularly unsuited for measuring natural resources programs, the ITA applied it to Canadian stumpage practices in October of the same year. On one point, however, the ITA seems to remain adamant. The appendix forthrightly rejects a tendency that has crept increasingly into various protectionist bills before Congress, namely, the tendency to use the United States as the comparative benchmark. There can be little doubt that beleaguered U.S. industries think of the United States as the relevant comparative benchmark. That is why allegations of "unfair" trade practices are made. And, as will be demonstrated in the following section, this popular perception is creeping into U.S. trade legislation.

New Definitions

The definition of upstream subsidies legislated in 1984 did not succeed in modifying the basis of the ITA's specificity/quantification test for domestic subsidies in such a way as to make programs like Mexico's natural gas pricing policy and British Columbia's stumpage programs countervailable. Neither did it provide a basis for ending the ITA's practice of refusing to use U.S. prices as the benchmark for

measurement of competitive advantage. Bill 4800, passed by the House of Representatives on May 22, 1986 (but never passed by the Senate), includes wording that would require the ITA to modify its approach to the specificity test, at least with respect to "resource input subsidies," and would force the ITA to go at least part way towards making U.S. prices the benchmark for comparative advantage.

Resource Input Subsidies, Input Products, and Removal Rights

In Bill 4800, new definitions of "input product" and "removal right" are linked to non-domestic market prices in such a way as to vitiate the ITA's specificity requirement. If this legislation becomes law, it could reach British Columbia's stumpage programs. It is the definition of "removal right" and the rules that govern it that would be applied to British Columbia's stumpage program.

> (a) GENERAL RULE. – A resource input subsidy exists if –
>
> . . .
>
> (2) the right to remove or extract a product (hereinafter in this section referred to as the "removal right") is provided or sold by a government or a government-regulated or controlled entity within a country and –
>
> (A) that product is for input use within that country;
>
> (B) the removal right is provided or sold at a domestic price that is lower than the fair market value of that right, and
>
> (C) the products to which the removal right applies would, if that right was sold at a fair market value, constitute a significant portion of the total cost of the manufacture or production of the merchandise in or for which the product is used.
>
> (b) AMOUNT OF RESOURCE INPUT SUBSIDIES. –
>
> (1) IN GENERAL. – The amount of a resource input subsidy is the difference between the domestic price of an input product, or of a removal right, and the fair market value of that product, or right, respectively.
>
> (2) EXCLUSIONS. – For purposes of this section, the terms "domestic price" and "fair market value" do not include, with respect to an input product, the costs incidental to the transportation and handling required

to move the product from its point of production to the respective domestic or foreign destination.

(c) DEFINITIONS AND RULES.—For purposes of this section—

(1) FAIR MARKET VALUE.—The term "fair market value" means—

. . .

(B) with respect to a removal right, the price that, in the absence of government regulation or control, a willing buyer would pay a willing seller in an arms-length transaction for the removal right in the country providing or selling the right.

. . .

(3) RULES FOR REMOVAL RIGHTS.—In determining the fair market value of a removal right, the administering authority shall take into account—

. . .

(A) the price paid in the exporting country for a comparable removal right not subject to government regulation or control;

(B) the price paid in the exporting country for a comparable removal right sold or offered for sale through a process of competitive bidding; and

(C) the price paid for a comparable removal right in comparable regions of countries other than the exporting country.

(4) INPUT USE.—The term "input use" refers to the use (directly or indirectly) of an input product in the manufacture or production of any class or kind of merchandise that is the subject of an investigation under this title.

This definition stipulates that if a country sells removal right at a price that is below fair market value, then the transaction is a countervailable subsidy. Fair market value is to be determined on the basis of a willing buyer-willing seller price that would be arrived at in the absence of government regulation or control. The ITA is to determine this price by considering:

1. the price paid in the exporting country for a comparable removal right not subject to government regulation or control

2. the price paid in the exporting country for a comparable removal right sold or offered for sale through a process of competitive bidding
3. the price paid for a comparable removal right in comparable regions of countries other than the exporting country.

The structuring of this definition seems deliberately to exclude the source of the specificity language – paragraph 1677(5)(B). A new subsection 1677(5)(C) refers to "resource input subsidy." This definition, like that of "upstream subsidy," is yet a further refinement of the domestic subsidy concept. For the first time, the ITA is directed by law (if the bill is passed by both houses of Congress and not vetoed by the president) to consider the price paid for comparable rights in comparable regions of other countries. This definition was tailor-made for British Columbia stumpage practices.[6]

The 1986 Phase of the Lumber Dispute

The ITA Determines that Stumpage Practices Are Subsidies

On October 16, 1986, the ITA delivered its preliminary determination with respect to the second Canadian softwood lumber countervailing duty action.[7] It decided that the stumpage programs of Alberta, British Columbia, Ontario, and Quebec were countervailable domestic subsidies within the meaning of paragraph 1677(5)(B). Two basic reasons were given by the ITA for its change of position with respect to stumpage practices. First, the *Cabot Corporation* case had forced it to re-evaluate the meaning of the specificity test. And second, although the ITA stated that it had received inadequate responses to its questions concerning the specificity of the provincial stumpage programs, the information it did receive, when supplemented with "reasonable inferences," convinced the ITA that stumpage programs were being specifically bestowed on the lumber industry and hence were in violation of the first aspect of the specificity test.

That the ITA re-evaluated its understanding of the legal meaning of the specificity test between the first and second rounds of the dispute is not surprising. In the *Cabot* case, the court made it very clear that

> the generally available benefits rule as developed and applied by the ITA is not an acceptable legal standard for determining the countervailability of benefits under section 1303. (620 F. Supp. 1985, 732)

In its first lumber decision, in 1983, the ITA observed that stumpage rights were available to a broad cross-section of industries; because they were as such "generally available," the ITA held that the programs were not in violation of the specificity criterion of the domestic subsidy test. In its second decision, in 1986, the ITA looked closely at how the various governments actually approved the allocation of stumpage rights and found that a good deal of discretion was involved which the ITA decided had the effect of skewing the allocation in favour of the lumber industry (as opposed to the furniture industry). This rationalization of specific bestowal was assisted by information which indicated that the lumber and pulp and paper industries were, in practice, vertically integrated. In its first decision, the ITA mentioned as being potential recipients of stumpage rights the lumber and wood products, veneer, plywood and building boards, pulp and paper, and furniture industries as well as various individual consumer industries producing turpentine, charcoal, wood alcohol and food additives, (and therefore since stumpage rights were generally available they were not subsidies). In its second decision, however, the ITA found that governmental discretion was exercised so as to give the lumber and pulp and paper industry a disproportionate share of the rights. Stumpage rights were specifically bestowed. The finding fits the *Cabot* decision's enunciation of the Court of International Trade's version of the correct rule quite closely:

> The appropriate standard focuses on the de facto case by case effect of benefits provided to recipients rather than on the nominal availability of benefits. (620 F. Supp. 1985, 732)

It is difficult to imagine how any government program designed to allocate natural resources to the private sector could not be in violation of this interpretation of the specificity test. The result is, of course, exactly what U.S. interest groups wanted to get out of their legal system, but a consideration of the reasoning employed by the ITA in reaching the result leads to the realization that it is absurd to consider this kind of rule as a normative standard for resolving trade disputes. The ITA, in an apologetic preamble to its 1986 decision, states that what it is actually doing in applying the specificity test is trying to determine if a given program is "unfair" (51 Fed. Reg., Oct. 22, 1986, 37456). It then moves on to what one must assume is consideration of the fairness of stumpage programs and observes that the exercise of governmental discretion in handing out stumpage rights does not result in allocation on a "first come first served basis." The implication of this reasoning is that the only fair exercise of a

resource owner's discretion is one which results in no discretion being exercised at all, i.e., first come first served.

In determining that the specifically bestowed stumpage rights also resulted in preferential treatment of the lumber industry, the ITA invoked the third benchmark of its Preferentiality Appendix, one that it had previously held was particularly unsuited for dealing with natural resources. An imputed value was given to provincially owned timber.

> While the provincial governments incur no direct costs for trees and the land on which they are situated, an imputed and indirect cost is associated with the intrinsic value of the tree and land. (51 Fed. Reg. 37457)

From this benchmark the ITA went on to calculate an estimated net subsidy of 14.542 per cent *ad valorem*.

What is disturbing about this decision is that it is supposedly an application of a legal rule that is to discriminate between fair and unfair trade practices. This particular application of the rule has led to the proposition that the exercise of any discretion by provincial governments in allocating a resource that (for historical reasons) has cost them nothing is unfair. To be fair, according to this interpretation of the rule, the provincial government must apparently pretend that it has incurred costs in obtaining the resource and must hand the resource out on a first-come-first-served basis. The absurdity of such a proposition can barely obscure the true meaning of the rule: if U.S. resource industries are suffering, foreign government ownership of any input products of competing natural resource imports is "unfair."

It is understandable that a nation would seek to protect a beleaguered industry. It is also understandable that it would use its legal system to do so. This particular technique, however, which classifies a foreign country's practice by reference to a rule which purports to isolate and penalize unfair trade practices, is devoid of any persuasiveness. It would be much easier to accept a remedy that defined commercial injury and provided a remedy for it, rather than to be subjected to a tortured definition of a particular kind of unfair trade practice that gives a politically desirable result while all the time seeking to maintain the façade of fairness.

The United States-Canada Memorandum of Understanding

On the eve of the ITA's final determination, the governments of Canada and the United States signed a Memorandum of

Understanding whereby Canada agreed to collect a 15 per cent export charge on softwood lumber products being exported to the United States, and the United States, on behalf of the Coalition for Fair Lumber Imports (the petitioner), agreed to withdraw its petition and the U.S. government, therefore, terminated the countervail action. (See Appendix B for the complete text of the memorandum; a side letter to the Understanding is cited in Chapter 5). Some implications of this Understanding are discussed in Chapter 2 and further comments with respect to it are made in Chapter 5. In this chapter, comment will be limited to several legal questions that the Understanding raises.

The Understanding was reached pursuant to subsection 1671c(a), which permits the ITA or the ITC to terminate a countervail investigation if the petition is withdrawn. The Understanding states that a notice of termination of the investigation will be signed after the petition is withdrawn. The Understanding, therefore, terminated the action. The legal landscape is clear; if the Understanding were to terminate, a new petition would be required, with no bonds or deposits collectable until another preliminary affirmative finding would be made. Fresh proceedings might allow the Canadian industry to regroup and fill in some of the gaps in their evidentiary case which the ITA had filled with "reasonable inferences."

The Understanding contemplates the replacement of export charges by increased stumpage or other charges at Canada's option. In such instances, Canada is to modify the export charges after consulting with the United States as to the calculation of the value of any replacement measures. To facilitate this arrangement, Canada has undertaken to ensure that no other governmental body in Canada takes any action to offset or reduce the export charge except that it be done in accordance with the Understanding. The legal issue raised by this undertaking is a constitutional one. Does the federal government have jurisdiction to compel the provinces to manage their forest resources in accordance with the Understanding? It is conceivable (and given Canadian resource management history, quite likely) that the federal government and a given province would disagree as to whether a given charge or change in stumpage was offsetting the export charge at all, and if so to what extent. It is very unlikely that the federal government could compel a province to do anything it didn't want to do with respect to replacement measures. Resource control and management is within provincial jurisdiction, while the federal trade and commerce power is relatively feeble. Canada has undertaken to do something on which it probably doesn't have the constitutional jurisdiction to follow through.

If one province decided to offset the export tax by increasing its stumpage fees, it could reasonably ask that the federal government

modify the export tax to accommodate the replacement measure. The federal government would be put in the position of being required to quantify the value of such a replacement and doing so in consultation with the United States. The value quantification might then have to be reflected in a reduction of the export tax to all exporters, regardless of which province they might be exporting from. It is difficult to imagine how the federal government might accomplish such a balancing act without legal power to compel a province to adopt or repeal a specific measure, while at the same time justifying the value of any modification to the United States.

On January 19, 1987, Bill C-37 (enacted in May 1987 as the Softwood Lumber Products Export Charge Act) was given first reading in Parliament. Like the Understanding that prefaced it, the bill is an awkward technique for trade management. Aside from the technical difficulties with which it abounds and which were alluded to by industry representatives in the Senate Banking and Trade and Commerce Committee hearings, the bill is subject to a broader kind of criticism of the government's legislative policy. The cumbersome, time-consuming legislative machinery of the federal government was tied up with this issue of trade management because the Understanding required enabling legislation. But a statute, as a legal device has limitations. It is, when enacted, relatively inflexible, and is typically difficult to repeal. Trade management would seem to require the opposite kind of mechanism—a flexible, adaptable technique that would allow for the inevitable upheavals and changes that characterize trade patterns. The Understanding itself, being a relatively innovative and *ad hoc* trade management device, can already be criticized as being deficient in a number of ways (see Chapter 5). Why clarify its provisions with a statute? The weaknesses of the Understanding are magnified as they are reflected in the statute. If the federal government is to devote its energies to trade-management legislation, it should give itself broad enabling powers with which to deal with a variety of situations on an ongoing basis and not tie its hands with narrow technical law based on a very tenuous Understanding.

Notes

1. A thorough analysis of U.S. legislation implementing the GATT subsidies code is found in Barcelo III (1980).

2. "As technological advances have increased the potential users of standing timber, stumpage has been made available to the new users. Any current limitations on use are not due to activities of the Canadian governments" (48 Fed. Reg. 1983, 24167).

3. The Canadian Softwood decision is mentioned in Barshefsky et al. (1985, 43).

4. The Mexican decisions are discussed in Bello and Holmer (1984, 308).

5. For an excellent analysis of the upstream subsidy concept see Giesen (1985).

6. Bill 4800 incorporated the resource input language from its predecessor, Bill 4750. The report on Bill 4750 discusses the input subsidy idea as it was perceived by the members of the Committee of Ways and Means, and the example of timber-pricing policies is specifically mentioned (U.S. 1985, 92-100, especially 99).

7. Preliminary Affirmative Countervailing Duty Determination: Certain Softwood Lumber Products from Canada (51 Fed. Reg., October 22, 1986, 37453). The final decision was scheduled for December 30, 1986. If it was affirmative, the ITC would have had 45 days to make a finding as to whether the subsidies materially injured or threatened to injure the U.S. industry.

Chapter 5:

The Political Economy of the Softwood Lumber Dispute

Political economy is the interaction between economic and political decision-making. Its study represents an effort to link the presumption that individuals and groups are motivated by economic self-interest with the expression of this self-interest through the political and legislative process. With the increasingly large role of government in society, both directly in terms of its share of economic activity and indirectly through its ability to regulate the operation of the market place, has come the awareness that many government decisions reduce rather than increase average economic well-being. An examination of political economy attempts to highlight the critical importance of distributional considerations in explaining government decision-making. The essence of political economy is who gets what and how. The "who" is discussed in terms of the distribution of the economic gains and losses from the policy under consideration. The "how" is discussed as a process of manipulating the political and institutional framework to achieve the desired distribution of income.

The political economy of protection – the political market for the use of tariff and non-tariff trade barriers to influence the pattern of trade – has been the focus of much attention.[1] The international trade policies of virtually all countries, at least with respect to protecting domestic producers, have little to do with enhancing national or global well-being. Just the reverse is true. In most cases a country's tariff and non-tariff barriers to trade reduce the average economic well-being of its residents compared with the situation of no trade barriers.[2] Yet the observation that trade barriers reduce economic

efficiency and lower national income ignores the primary reason for their existence – the distribution of income which they generate. It is fair to say that most government policies in the area of trade have little to do with increasing the size of the economic pie and far more to do with the disposition and size of the slices. Unfortunately, in the process of dividing the spoils a lot of economic waste is generated and so the size of the economic pie is reduced.

This chapter provides a brief overview of the political economy of the Softwood Lumber dispute. It is brief because the topic lends itself either to book-length treatment or to a mere highlighting of key factors, and here the latter is obviously appropriate. The discussion begins with a review of the politics of protection and their influence on quasi-judicial trade agencies such as the International Trade Administration (ITA) and International Trade Commission (ITC). With this background we then turn to a discussion of the distribution within the United States of the costs and benefits of erecting barriers to trade in softwood lumber. The Canadian negotiation strategy in the dispute is then briefly assessed, with the question being whether the December 30, 1986, agreement was the best outcome possible in light of U.S. politics. The chapter concludes with a discussion of the implications of the Softwood Lumber dispute for the outcome and content of Canada-United States free trade negotiations.

Politics and Protection

Economists have long been united in arguing that protection whether in the form of tariff or non-tariff barriers, reduces national income. It does little for the profession's collective pride to note that trade barriers are universal and constitute an integral element of every country's commercial policy. Before we explain this apparent paradox and its link to political economy, it would be useful to outline how protection influences our economy.

Protection reduces national income because it permits less efficient industries to expand or maintain current levels of production by letting them shelter behind the higher domestic prices afforded by trade barriers. There are economic gains to some groups but the losses to others outweigh them. The increase in domestic prices permits the protected industry to use capital and labour that could be used more efficiently elsewhere in the economy, for example, in the services or export sectors. Therefore, the economic activity induced or maintained in the protected sector of the economy is more than offset by the production that is forgone elsewhere. Consumer welfare is also reduced. Higher prices brought about by protection lead to a reduction in consumption of the protected commodity. A portion of the consumer's expenditures is redirected to other goods, but the

expansion of consumption elsewhere is still less than the fall in consumption of the protected good. These two sets of net losses – in production and consumption – constitute the fall in national income, or the efficiency loss, due to protection.

Were these efficiency losses the end of the story, rational voters would always opt for no trade barriers in preference to protection, as higher incomes would result. This naive approach neglects the income-distribution consequences of protection. The increase in prices brought about by protection leads to a redistribution of income from consumers to producers. The protected industry's revenues and profits will increase as a consequence of protection. There are other income redistributions that result from protection. Government revenues will increase by the amount of tariff revenues collected, while the holders of quota rights to imports, if protection takes this form, will receive large economic profits.

In many cases, the magnitude of the income-distribution consequences of protection swamp the efficiency effects, at least from the perspective of most residents. Hufbauer et al. (1986, Table 1.2) have estimated the distribution of costs and benefits from special protection for a variety of U.S. industries. For example, the authors estimate the efficiency loss of quantitative restraints on textiles and apparel (phase III of restrictions) at US$4.85 billion. The gain from restraints to producers is calculated at $22.0 billion or $11,100 per job saved. The cost of restraints to consumers is estimated at $27.0 billion or $42,000 per job. For their sample of 31 industries Hufbauer et al. (1986, 16) find that consumer "costs per production job saved are quite large, usually in the range of $20,000 to $100,000 per year, and often exceeding $150,000."

It is the distribution of these gains and losses that is critical in understanding the role of pressure groups in promoting or opposing protection. The ideal scenario for protection is the case where the costs of protection are diffused over large numbers of consumers who themselves are widely dispersed, while producer gains are heavily concentrated. Under these circumstances it will be too costly for individual consumers to organize into pressure groups to lobby for less protection. The gains they might expect from such efforts are more than offset by the costs (in time and money) of creating and maintaining the pressure group. On the other hand, the concentration of gains to producers makes it profitable for them to invest considerable time and effort, through the political process, in either maintaining or increasing protection.

Other factors in the "market" for protection also influence the "demand" for protection and the response of politicians to it. Industries that are labour intensive and whose work force is unskilled are often successful particularly if the industry is regionally

concentrated. The political costs of high concentrations of unemployment – even if this unemployment is temporary and reflects a period of adjustment before labour seeks employment opportunities elsewhere – are perceived to outweigh the gains from a more efficient allocation of society's resources.[3] Industries that are highly concentrated also appear to be successful in obtaining protection.

The resource and resource-processing industries in the United States are uniquely situated politically with respect to their ability to exploit U.S. trade laws for protection from imports. The mining, energy, and forest resource extraction and processing industries are regionally concentrated; within these regions many communities are single-industry ones whose very economic viability depends upon the resource in question. Such communities are able to exert tremendous political pressure on elected representatives especially in the U.S. Senate, where regional interests are often most effectively represented at the national level. Moreover, political lobbying for trade protection by the resource industries themselves yields economic benefits which are both large and often highly concentrated. Thus, there are the incentives and means, both financial and political, for troubled resource industries to promote policies that on the whole are costly, as they lower national income, but from the perspective of the industry in question are highly desirable, as they increase or at least maintain incomes, employment, and profits.

Both structural characteristics and political factors have made the softwood lumber industry of the United States a prime candidate for some form of contingent protection. In fact, in light of the importance of these factors, what is really surprising is the failure of the industry to obtain protection in 1983, rather than its preliminary success before quasi-judicial trade bodies in 1986. The forest products industry, particularly the lumber and wood products component, is a significant element of the "economic base" of the Pacific Northwest and certain states of the U.S. South. The economic base of a region is defined in terms of the shares in employment or earnings of industries in that region in excess of the shares for those industries in the national economy. By this definition the forest products industry is the most important industry in the economic base of Oregon; it accounted for 38.3 per cent and 44.7 per cent of the economic base when defined in terms of employment and earnings, respectively, in 1980 (Schallau and Maki 1986, 4). For Washington the forest products industry was the second most important industry after transportation equipment (e.g., aircraft) and accounted for 16.2 per cent of the economic base in terms of employment and 18.5 per cent in terms of earnings in 1980 (Schallau and Maki 1986, 5). In both states the importance of the forest products industry to the economic base has declined from 1970 to 1980.

The forest products industry of the South accounts for a much smaller share of the economic base of the region than in the Pacific Northwest. Moreover, the lumber and wood products industry is far more important in the forest products industry of the Pacific Northwest than of the South. For the former, 78 per cent of industry employment (144,423 workers) was in lumber and wood products, while for the latter the share of industry employment (620,567) was 41 per cent (Schallau and Maki 1986, 14). Arkansas was the southern state most dependent on forest products; in 1980, the industry accounted for 16.6 per cent of the economic base defined in terms of employment, a level comparable to that of Washington (Schallau and Maki 1986, 12). However, between 1970 and 1980 the contribution of the forest industry to the economic base of a number of southern states – including North Carolina, Mississippi, Alabama, Tennessee, Virginia, and South Carolina – increased.

Employment in the lumber and wood products industry has been falling, particularly in the Pacific Northwest, because of timber-supply constraints and technological change. The causes of this decline have been known for some time. Wall (1973) 17 years ago forecast that employment in the wood products industries of the Douglas Fir region of the Pacific Northwest would decline by 45 per cent, or 55,000 jobs, by the year 2000. The substitution of capital for labour would account for 36 percentage points of the anticipated decline and a lack of timber (the "falldown") for the remaining 9 percentage points.

The labour-saving bias of technological change has been confirmed by a number of studies of both the Canadian and U.S. wood products industries.[4] The growth of average labour productivity discussed in Chapter 2 reflects this technological change and means that additional growth in output can be satisfied with fewer workers. The evidence of Table 5.1 suggests that employment levels achieved in 1979 have not been regained, and this pattern is virtually uniform across the Pacific Northwest and British Columbia. Workers released during the downturn in lumber demand associated with high real interest rates have not been rehired, nor is it likely they will be.

The forest products industry, especially the lumber and wood products component, is by its very nature often associated with single-industry communities. It is difficult for such communities to cope with secular decline in employment in the economic base of the region, as alternative employment opportunities are often not present. The bias of technological change towards labour-saving techniques, combined with the impact of the U.S. Forest Service's timber-harvesting constraints, has had a particularly severe impact on the Pacific Northwest as a consequence of the lumber and wood products contribution to the economic base.

Table 5.1
Employment in Lumber and Wood Products in Northwest Forest Industries, Canada and the United States, 1974-1985
(thousands)

	British Columbia	United States Pacific Northwest						
		Montana	Idaho	California	Washington	Oregon	Alaska	Total
1974	44.9	9.5	14.6	50.9	49.7	74.8	2.5	202.0
1975	38.7	8.1	15.7	52.8	43.8	67.0	2.0	189.4
1976	44.6	9.1	17.4	59.9	51.0	72.4	2.3	212.1
1977	47.6	9.3	17.8	66.6	53.9	77.5	2.2	227.3
1978	51.0	10.7	18.8	69.9	55.1	81.4	1.8	237.7
1979	51.4	11.1	18.5	68.7	52.6	80.8	2.0	233.7
1980	49.7	8.7	16.1	62.6	46.5	69.6	2.3	205.8
1981	46.6	8.8	15.1	57.9	44.4	63.7	1.9	191.8
1982	40.3	6.8	12.1	46.2	39.0	55.5	1.8	161.4
1983	40.4	8.0	14.0	50.2	41.0	52.0	1.9	167.1
1984	-	8.3	13.9	55.4	41.0	65.2	1.6	185.4
1985	-	8.4	13.6	-	37.3	64.2	-	-

Sources: (For B.C.) "Selected Forestry Statistics Canada 1985," Canadian Forestry Service Information Report E-X-37, April 1986.
(For U.S. Pacific Northwest) Debra W. Warren, "Production, Prices, Employment, and Trade in Northwest Forest Industries, Fourth Quarter 1985," Resource Bulletin PNW-130 (Washington, D.C.: U.S. Dept. of Agriculture Forest Service, April 1986).

Note: Dash (-) means not available.

The economic importance of the forest products industry to the Pacific Northwest has led its senators and congressmen to be vigorous advocates on its behalf. Moreover, senators from timber-producing states were particularly well placed on important committees during the first session of the Ninety-ninth Congress to bring the Softwood Lumber dispute to the centre of attention and highlight the need (from their perspective) for contingent protection. For example, Robert Packwood (Republican, Oregon) was chairman of the Senate Finance Committee and member of the Finance Sub-committee on International Trade headed by John Danforth (Republican, Missouri); Senators Max Baucus (Democrat, Montana), Malcolm Wallop (Republican, Idaho), and Steven Syms (Republican, Idaho) were members of both the Finance Committee and its International Trade Subcommittee; David Pryor (Democrat, Arkansas), from a southern state with a large forest products industry, was also on both committees.

The members of the Senate Finance Committee were uniquely positioned in the spring of 1986 to exert pressure on the Administration over the Softwood Lumber dispute. In December, the Executive had requested permission from Congress to proceed with free trade talks with Canada. The House Ways and Means Committee readily gave approval, but in the Senate the Finance Committee in mid-April appeared ready to reject the request. In light of the composition of the committee, trade in wood products between Canada and the United States became inextricably linked to granting the Administration approval for proceeding with free trade talks with Canada.

Max Baucus was a particularly outspoken critic of Canada's timber-pricing policies and, in late February 1986, specifically linked his approval for free trade talks with Canada to a resolution of the Softwood Lumber dispute (*Globe and Mail* 1986a). Similarly, Senator Packwood was said by an aide to be "compelled to oppose [free trade] negotiations if no solution (to the Softwood Lumber dispute) appears" (*Globe and Mail* 1986a). Senators Dole (Republican, Kansas) and Danforth also expressed concern over the Softwood Lumber dispute adversely affecting Finance Committee deliberations regarding approval for proceeding with free trade talks.

One measure of the visibility that the Softwood Lumber dispute had achieved was the ability of Senator Baucus on February 26, 1986, to muster 15 senators, primarily from lumber-producing states, to warn Canada from the floor of the Senate to reduce softwood lumber exports or face the consequences. A further 25 senators provided written comments along similar lines for the record. Eleven out of 20 members of the Senate Finance Committee either spoke or provided

written comments warning Canada about the Softwood Lumber dispute (*Globe and Mail* 1986a).

By mid-April of 1986 there was a real fear that the Senate Finance Committee would reject the Administration's request for free trade talks with Canada. The Executive's response was to attempt to placate forest industry representatives and their congressional allies. The U.S. Trade Representative (U.S.T.R.), Clayton Yeutter, spoke with industry officials and noted that a recent Commerce ruling had widened the notion of an export subsidy, thereby making a new countervail petition more likely to succeed. Commerce and U.S.T.R. officials also briefed senators from lumber-producing states regarding the new interpretation by Commerce (*Globe and Mail* 1986b; *Financial Post* 1986a). The actual vote by the Finance Committee after Administration lobbying was a 10 to 10 tie, which permitted the free trade negotiations with Canada to proceed.

The closeness of the vote was a clear signal to the Administration that the Softwood Lumber dispute had significant political ramifications. From the perspective of the Department of Commerce it was clear that failure to obtain a satisfactory outcome in the Softwood Lumber dispute through provisions of existing legislation would provoke a legislative response which would be aimed specifically at stumpage but would probably spill over into other trade areas. Certainly, one cannot escape the impression that Commerce clearly signalled that this round it would treat countervail proceedings in softwood lumber more favourably than it had in the past.

The Coalition for Fair Lumber Imports was the main industry pressure group lobbying for action against lumber. The coalition is composed of a number of softwood lumber producer associations and major forest products corporations accounting for over 70 per cent of production in the United States. Much of the effort of the coalition was directed to putting the industry's case forward in Washington. An interview given by David J.J. Wang, a senior vice-president of International Paper, provides an excellent overview of the political tactics employed by the coalition. In response to a question regarding industry influence in Washington, Wang noted:

> Our influence in Washington has increased because the effort put into it has increased many fold. We have become more successful in reaching high levels of the Administration as well as influential members of Congress. Our grass-roots campaign has involved companies and individuals with a personal stake. We have also increased the quality of our communications by engaging public relations firms to make the necessary contacts and law

> firms to get our case across in detail. (*Forest Industries* 1986, 28-29)

Wang also commented on the important role played by senior management in major firms, such as Georgia-Pacific and International Paper, in advancing the coalition's argument against Canadian imports. Wang, however, credits the Commerce decision in April 1986 in the Cabot case (dealing with Carbon Black from Mexico) as changing the Administration's position on softwood lumber.

The Impact of Protection for the Softwood Lumber Industry on U.S. Consumers and Producers

The agreement by Canada to impose a 15 per cent export tax on softwood lumber destined for the U.S. market will cause the landed price of Canadian softwood lumber in the United States to rise and the producer price in Canada to fall. However, the distribution of the burden of the export tax between U.S. consumers and Canadian producers depends critically on the responsiveness of softwood lumber supply and demand in the two countries. The less responsive that U.S. supply and demand are to price changes, the greater the burden of the tax borne by U.S. consumers and the less by Canadian producers. Most estimates suggest that U.S. softwood lumber supply and demand are quite unresponsive to price changes, at least in the short run. Consequently, a significant portion of the burden of the tax will be borne by U.S. consumers. Moreover, it has been difficult to assess the immediate impact of the export tax on U.S. lumber products. Demand has been strong in the United States and the effect of a four-month strike (prior to the imposition of the export tax) in the British Columbia forest industry was to reduce lumber inventories. However, Canada's share of the U.S. lumber market declined to 28.7 per cent in the first two months of 1987, down from 31.5 per cent a year earlier (*Globe and Mail* 1987h). Within Canada there certainly is no consensus regarding the potential impact of the tax.[5]

The pay-off to the U.S. softwood lumber industry is highlighted in a study by the Citizens for a Sound Economy; Melrose et al. (1986, 4-5) cite a range of estimates of the impact of U.S. tariffs on Canadian softwood lumber imports. Although Canada in fact imposed the duty and thus retained the revenues that otherwise would have accrued to the U.S. Treasury, the effects remain basically the same. Melrose et al. provide an estimate by the Congressional Budget Office that finds a 13.5 per cent lumber tariff would generate consumer losses of up to $1 billion. The results of a Wharton Econometrics (1985) forecasting exercise are also discussed. A 15 per cent increase in the price of softwood lumber (full tariff incidence borne by U.S. consumers) would

"save" or maintain only 5,508 jobs in the U.S. lumber industry while creating new job losses of 16,601 because of the adverse impact of higher lumber prices on employment in lumber-using industries such as construction. Forty-six states including the District of Columbia would experience net job losses. Only the states of Alabama, Georgia, Mississippi, and Oregon would experience net job gains. Melrose et al. (1986, 4) estimate the cost of each job saved at $721,000.

These results highlight the distributional consequences of protection discussed earlier. The losses are dispersed over large numbers of consumers and for each individual or group, are very small relative to the costs of lobbying for free trade in lumber. The benefits of protection, however, are large and are heavily concentrated.

Much of the redistribution of income from U.S. consumers to softwood lumber producers ultimately will accrue to the owners of the timber base, in the form of higher revenues through bids for timber. Higher softwood lumber prices will encourage firms to expand production; to do so, they must obtain timber. Competition among softwood lumber producers will be reflected in higher bids for stumpage or, for vertically integrated firms holding land in fee simple status, a higher shadow price for timber. The latter firms will experience a significant capital gain as their timber holdings will now become more valuable.

What is ironic in the entire exercise is that many of the small timber producers in the U.S. Pacific Northwest and South will not benefit to the extent anticipated. The big winner in the Pacific Northwest will be the U.S. Forest Service. National Forests constitute the bulk of the commercial timber supply, and higher lumber prices will lead to higher bids for harvest rights from federal lands.

Owners of land in fee simple status will be the other main beneficiaries of protection. Not surprisingly, International Paper and Georgia-Pacific, two of the major corporate sponsors of the U.S. Coalition for Fair Lumber Imports, stand to be big winners as both account for a large share of softwood lumber production and hold large tracts of timber in fee simple status. In 1985 Georgia-Pacific and International Paper accounted for 1.5 billion board feet and 0.7 billion board feet, respectively, of softwood lumber production. The two companies jointly accounted for 7.2 per cent of total U.S. softwood lumber production (*Forest Industries* 1986, 14-16). International Paper Company, through its ownership of IP Timberlands, Ltd., controlled approximately 6.7 million acres of timber lands in the United States with an unamortized cost of $741 million (International Paper Company 1985, 40). Georgia-Pacific owns approximately 4.9 million acres (including 275,000 acres purchased during 1984) and controls "approximately 480,000 additional acres of timber lands in North America" (Securities and Exchange Commission 1984, 4).

Virtually all of Georgia-Pacific land is in the United States except for 373,000 acres in fee simple status in New Brunswick.

When one reviews the political and economic clout of the various participants acting on behalf of the U.S. softwood lumber industry it becomes clear Canada could not have won the case on its economic merits. Congressmen and senators, especially from timber-producing states, were in a position to link free trade talks to the Softwood Lumber dispute and possibly extract concessions from the Administration with regard to the application of various trade remedies. The politicians were protecting the interests of their constituents and their own prospects for re-election. Declining employment and investment in an industry that constitutes a major component of a region's economic base at a time of increasing import penetration would have made it very difficult for senators to advocate free trade with Canada. The executive branch, and departments such as the Department of Commerce, feared the emergence of protectionist legislation aimed at resource input subsidies. A failure to solve the dispute on terms satisfactory to the U.S. industry would have acted as a catalyst for legislation in this area. Finally, the U.S. Coalition for Fair Lumber Imports channeled much of its efforts to the political front in Washington and raised the visibility of the dispute enormously. Their efforts to portray themselves as aggrieved parties were tremendously successful because rarely were the merits of the Canadian case referred to in either Canadian or U.S. media.

The Memorandum of Understanding, December 30, 1986

Settling the Softwood Lumber Dispute

As the deadline of December 30, 1986, approached, it appeared highly unlikely to Canadian negotiators that the final determination by the ITA on the issue of subsidy would be in Canada's favour. The contrived and *ad hoc* nature of the ITA's preliminary determination clearly indicated that the ruling was much more likely to be decided on its political rather than economic merits. Moreover, the U.S. Coalition for Fair Lumber Imports claimed that the preliminary determination of a 15 per cent countervailable subsidy was too low and was arguing for one of 32 per cent. Beyond the Softwood case itself, the Canadian government must have feared that a final determination by the ITA against Canada would create a precedent that could be applied to other Canadian resource and resource-processing industries. In light of such considerations the Canadian government signed a Memorandum of Understanding (hereafter referred to as "the Understanding") with the U.S. government which

led the coalition to withdraw its petition and terminate countervail proceedings. Comments on the legal aspects of the Understanding are made in Chapter 4; the events leading up to the Understanding and the implications of it are discussed in greater detail here and the text of the Understanding is provided in Appendix B.

The Understanding calls for Canada to levy a 15 per cent *ad valorem* export tax on the f.o.b. final mill price of softwood lumber exports to the United States. The Understanding extends beyond just dimension lumber. The rough softwood lumber inputs in a variety of further manufactured products are also liable to the 15 per cent *ad valorem* export tax. The export duty can be reduced or eliminated by the federal government on the basis of increased stumpage or other charges by the provinces on logs used in softwood lumber production. Although the United States has no say in the specification of replacement charges adopted in lieu of the export tax, Canada is committed to consulting with the United States on the value of the replacement charges. Provision is made for monitoring provincial and federal data regarding softwood and total harvest levels, federal and provincial revenues from timber production, export volumes to the United States, and revenues collected under the export charge.

The most controversial aspects of the Understanding related to "side" letters accompanying the document and to undertakings with respect to the Understanding given by the U.S. government to the U.S. Coalition for Fair Lumber Imports. The U.S. side letter concerns circumvention by Canada of the conditions of the agreement and states:

> The Government of the United States of America considers that the rebate, remission, deferral or non-collection of the export charge, except as provided for in the Understanding could have the effect of offsetting or reducing the export charge within the meaning of paragraph 6 of the Understanding. Further, the Government of the United States of America considers that other actions, including a reduction in the price of stumpage or other charges and the assumptions of obligations currently borne by producers or exporters of certain softwood lumber, could have the same effect and give rise to the consultations regarding their effect. (U.S. Trade Representative 1986b)

This side letter provides a context for the U.S. interpretation of the Understanding as conveyed by Malcolm Baldrige, secretary of commerce, and by Clayton Yeutter, U.S. Trade Representative, to Stanley S. Dennison, chairman of the U.S. Coalition for Fair Lumber Imports, in a letter dated December 30, 1986. It is worth citing this

letter at length because it does provide a clear outline of how the U.S. government views the Understanding. The letter notes that "these understandings have been conveyed to the Government of Canada although they have not been explicitly expressed in the agreement."

The U.S. government understanding of key provisions of the Understanding are:

> First, as the 15 per cent export charge is a substitute for a countervailing duty, and is being imposed for the purpose of offsetting Canadian stumpage subsidies, the U.S. Government intends that collection of the charge will begin immediately upon withdrawal of the countervailing duty petition, effective on cessation of bonding. The charge may be collected by either the Government of Canada or the Government of the United States. We intend that the charges will be collected until agreed replacement measures have the equivalent economic impact on average on each unit of exports to the United States as the 15 percent charge or that portion of it which is being replaced. The United States would not object to replacement measures being implemented by individual provinces and the export charge being reduced or eliminated accordingly for such provinces.
>
> Second, the U.S. Government will monitor closely the operation of this agreement to insure that the amounts collected through the export charge or replacement measures are not returned to or otherwise used to benefit producers or exporters of Canadian softwood lumber.
>
> Third, it is the understanding of the U.S. Government that the Canadian export charge on softwood lumber will result in the collection of at least $500 million ($Can) per year. This assumes that the quantity and/or price of lumber exported from Canada to the United States does not decline substantially, because of a 15 percent countervailing duty on the current level of Canadian softwood lumber imports would have resulted in collections of at least this amount, and it is the intent of both governments to replace the preliminary countervailing duty with an export charge of roughly equivalent effect.
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> Fourth, it is the understanding of the U.S. Government that the U.S. Government would have to approve any changes in the export charge or calculation of the value of any replacement measures. Any changes made without U.S. Government approval would be considered a violation of the Understanding.

Fifth, it is the understanding of the U.S. Government that after the export charge has been reduced because of the imposition of replacement measures, the Government of Canada will restore the export charge to the extent necessary to offset any subsequent change in the replacement measures such that they no longer have the equivalent impact on exports as the 15 percent charge or that portion of it which has been replaced.

Sixth, should the Canadian Government breach its obligations under the Understanding or terminate this agreement, the U.S. Government will take all appropriate actions (such as acting under section 301 of the Trade Act of 1974 to impose import duties equal to the charges which the agreement contemplated would have been collected by the Government of Canada and/or the provincial government) in response to the failure by the Government of Canada to meet the objectives and commitments of the Understanding.

Seventh, the U.S. Government will consult closely with petitioner, the Coalition for Fair Lumber Imports (Coalition), concerning implementation and operation of this agreement and provide information to assist the Coalition to evaluate the operation and enforcement of this agreement. Specifically, the U.S. Government will not agree to any elimination or reduction of the export charge without prior consultation with the Coalition.

Eighth, nothing in this agreement will prejudice the consideration by the Department of Commerce of a petition on behalf of producers of products not enumerated in the Understanding. We would not consider such a petition to be inconsistent with the agreement or its enforcement.

Ninth, we will monitor the level of shipments from the companies exempted from the export charge and if the data show substantial increases from prior years, we will consult with the Government of Canada to ensure that the objectives of the Understanding are not being undermined by the exemption provision.

Tenth, we would consider that the followup [sic] actions by the governmental bodies in Canada could have the effect of offsetting or reducing the export charge or replacement measures within the meaning of paragraph 6 of the Understanding.

(1) rebate, remission, deferral, or non-collection of the export charge, except as provided in the Understanding; (2) the provision of grants, low-cost

> loans and other benefits; (3) exemption from obligations otherwise imposed by the Government of Canada and other governmental bodies in Canada; (4) assumption of obligations currently borne by the producers or exporters of certain softwood lumber products; (5) reduction in the price of stumpage or other charges on softwood timber harvested from provincial Crown lands; (6) changes in log scaling or lumber measurement rules or procedures which affect volume determination; and (7) awarding contracts for silviculture, roadbuilding, recreational, and other foresting activities on a noncompetitive basis. (U.S. Trade Representative 1986a)

The Canadian government also has a side letter accompanying the Understanding. This letter notes that the objective of the Understanding "involves not only settlement of the dispute over the countervailing duty investigation, but also avoiding enactment of legislated restrictions or further investigations under U.S. trade laws." Canada reserved the right to terminate the Understanding should the industry again become subject to the U.S. trade remedies.

Unresolved Issue 1: United States-Canada Trade in Softwood Lumber

The Understanding has been rationalized on pragmatic grounds as the best that Canada could do in light of the increasing protectionist sentiment in the United States and the political dimensions of the case. It was seen as more desirable to keep the tax revenues in Canada through an export tax rather than to have them accrue to the U.S. Treasury through imposition of a countervailing duty. Unfortunately, the Understanding is utterly deficient in terms of defining the economic merits of the case. The key issue – whether market forces brought about by exchange rate movements and industry productivity account for increased Canadian penetration of the U.S. market or whether the cause lies in timber-pricing policies – is neglected entirely.

The Understanding explicitly states in the General Provisions (item 3(b)):

> This understanding is without prejudice to the position of either government as to whether the stumpage programs and practices of Canadian governments constitute subsidies...

Yet the Understanding *implicitly* treats the allegation of subsidy as correct. Otherwise, the Understanding would not have as its ultimate objective an increase in stumpage fees and other charges to a level equivalent to the 15 per cent *ad valorem* export tax. What happens if, as the data suggest, it was the exchange rate that was responsible for a portion of increased Canadian market penetration since 1983, and suddenly in the future the Canadian dollar appreciates? Canadian softwood lumber producers would find their competitive position in the U.S. market eroded by the joint effects of the export tax and the appreciation of the Canadian dollar. A major problem with the Understanding is that there is no link between the rate of the *ad valorem* export tax and those market factors that appear in large part to account for increased Canadian penetration of the U.S. softwood lumber market since 1983. The economic effect of the Understanding is to offset the market-determined advantages of Canadian producers in the U.S. market.

As mentioned earlier in this chapter, the actual burden of the export tax is hard to calculate and depends on the responsiveness of supply and demand of softwood lumber in the United States to price movement. However, the evidence suggests that both supply and demand, at least in the short run, are relatively unresponsive to price movements. Consequently, a portion of the export tax will be passed on to U.S. consumers in the form of higher prices. Undoubtedly, some portion of it will be borne by Canadian softwood lumber producers in the form of lower prices received by producers for end-products. Consequently, in British Columbia, holding all other market forces constant, stumpage values will fall as a result of the Understanding. Certainly from the perspective of U.S. lumber producers it will look like the province is offsetting the tax and increasing the amount of subsidy!

Perhaps of greater concern are the signals that the Understanding sends out to those contemplating investments in the Canadian forest industry or all resource industries dependent on the U.S. market. The free trade which had prevailed in the forest sector until the December 30, 1986, Understanding had led to the emergence in Canada of world-class mills specialized in the production of dimension lumber for the U.S. market. Investors will now think twice about investments in equipment and plant specialized for the U.S. market in light of uncertain or costly access. It was such investments and their positive effect on productivity that enhanced the competitive position of the industry in the United States market. Trade restrictions thus prevent investors from realizing the profits that had been anticipated.

The last quarter of 1986 and first quarter of 1987 saw sharp increases in the value of trade shares of most forest companies on

stock markets in Canada and the United States. However, this rise in share prices is related to cyclical demand factors and is probably not indicative of the long-term impact of the Understanding. The wood products and pulp and paper industries may find it increasingly difficult in general to raise funds in the open market to finance plant modernization and expansion. Such an outcome, and the adverse consequences for productivity, would have serious repercussions for the Canadian economy as a whole because of the importance of the industry. Obviously a strong market for lumber in the United States may in the short run offset some of the effects of the export tax on export prices. But declining demand in the United States or a rise in the value of the Canadian dollar will ultimately lead to some of the burden of the export tax being borne by Canadian producers. Moreover, any effort by Canadian governments to help alleviate the capital market squeeze on these industries would be viewed by the U.S. government as a circumvention of the Understanding and would provoke retaliation.

Unresolved Issue 2: Division of the Spoils among the Provinces

The Understanding does not discuss the division of the export tax revenues among the provinces. This omission is not surprising, as the allocation is a Canadian matter alone. Yet clearly the Americans, at least in their side letter accompanying the Memorandum, did not want the revenues returning to the provinces in a way that could be viewed as helping to offset the economic impact of the tax on the wood products industry. The U.S. government will, in light of the Understanding, carefully scrutinize those federal transfers to the provinces that are related to the forest sector, to see if they can be interpreted as offsetting the impact of the export tax. This constraint may also make it difficult for Canadian governments, both federal and provincial, to promote the development of forest products industries in northern communities, where such industries may be the only potential source of employment. Yet regional development programs of this nature, particularly those involving subsidies or tax concessions would have been subject to countervail proceedings in any case.

What is surprising is the failure of the Canadian negotiators of the Understanding, and their advisers, to anticipate problems in the allocation of the funds among the provinces. How is the anticipated $500 million each year to be distributed? On the basis of provincial softwood lumber production? The volume of exports to the United States? Or is the allocation to be based on more complicated criteria such as the extent to which a province's stumpage fees appear "too low"? What happens to export tax revenues from British Columbia

softwood lumber reloaded in Ontario and Quebec and exported to the United States – which province gets it?

Federal-provincial fiscal relations, especially dealing with the taxation of resource revenues, have always been a contentious issue in Canada. The dispute between Alberta and Ottawa over the division of energy revenues is probably the most visible example. What is so surprising about this agreement is the willingness of provinces such as British Columbia, Alberta, and Quebec to endorse it; in the past, these very provinces have been the most vociferous critics of federal efforts to tax resource revenues and have been most protective of provincial sovereignty.

Unresolved Issue 3: Substitutes for the Export Tax

A further policy issue that stems from the Understanding is the feasibility of the provinces' ever adopting replacement charges for the export tax. At least at the time of completing this study, this issue has not been resolved. The evidence suggests that market forces rather than underpriced stumpage were primarily responsible for the increase in Canadian softwood lumber exports to the United States. Under these circumstances provinces will find it very difficult to increase stumpage fees and charges, because they would then be assuming responsibility for increasing unemployment and driving a number of firms out of business in the forest sector. It is something of a Canadian tradition that a lower order of government permits the higher orders of government to bear responsibility for politically and economically damaging policies.

Moreover, the actual mechanics of increasing stumpage fees to a level that would generate revenue equivalent to the 15 per cent export tax are very complex. The ITA preferentiality test found that some provinces "subsidized" their commercial timber-harvesting operations to a greater extent than others did. Since the ITA test is totally without merit, should all the provinces raise their stumpage charges and other fees by the same amount? And again, what about those provinces that were not the subject of countervail proceedings? What should they do? Furthermore, every province has an incentive to minimize the increase in its stumpage or royalty fees in the hope that other provinces will undertake changes that will generate a larger share of the required replacement amount. The Understanding has created tremendous incentives for provinces to behave strategically with respect to changes in their timber-pricing policies. It is difficult to see how the provinces will voluntarily come to an agreement regarding substitutes for the 15 per cent export tax.

An additional problem is that increases in provincial stumpage prices will affect *all* industries that use timber, not just the softwood lumber industry. For example, the pulp and paper industry would have to pay higher timber prices despite the fact they were not a party to the original countervail suit. Moreover, stumpage prices will have to rise by more than 15 per cent if they are to generate the equivalent of the 15 per cent export tax. Thus the replacement of the export tax will be a very contentious issue for each province.

A meeting of provincial forestry ministers in Winnipeg on June 1, 1987, failed to produce a comprehensive substitute package to replace the current export duty. All provinces with the exception of Ontario offered Ottawa a combination of provincial increases in stumpage, other timber fees and other product taxes as a replacement package. The nature of the package differs from province to province. Quebec, for example, has already raised stumpage fees by more than half the 15 per cent required in the Understanding. It is considering making up the remainder by depositing the balance in a forestry fund similar in design to the Alberta Heritage Savings Trust Fund. Ontario has continued to argue that the export tax should remain in place until full assessment has been made of the consequences for the forest industry of the December 30, 1986, Understanding. In addition, the Ontario forestry minister has argued that it is easier to negotiate away the export tax in the context of the Canada-U.S. free trade talks, if the opportunity arises, than to change the timber-pricing system (*Globe and Mail* 1987i).

Could Canada Have Done Better?

The Canadian government reached the agreement of December 30, 1986, for pragmatic reasons. The agreement can best be viewed as a salvage operation. The available evidence suggested that the final determination by the ITA on the issue of subsidy was going to be against Canada. The U.S. Department of Commerce (DOC) appeared very supportive of the position of the Coalition for Fair Lumber Imports regarding withdrawal of the petition. For example, Desirée Tucker, a spokesman for the DOC stated on December 14, 1986: "We are puzzled by the Canadians' unwillingness to reach a solution. The U.S. industry has done everything it could to accommodate the Canadian concerns" (*Globe and Mail* 1986f). The shift of the DOC from arbitrator to advocate was not a hopeful sign for Canadian negotiators. At the same time, while the U.S. Department of Commerce worked very closely with the U.S. Coalition for Fair Lumber Imports, the Canadian Forest Industries Council was not an active participant with the Canadian government in reaching the Memorandum of Understanding. A negotiated settlement, with

Canada imposing an export tax, would at least retain tax revenues in Canada rather than having them accrue to the United States.

The sticking point in negotiations from October 1986 on, however, had been the issue of Canadian sovereignty over resource pricing and the value of the tax. Canadian negotiators wished to restrict the discussion to the value of the study raised and leave the mechanics of the replacement of the export levy as issues for discussion among Canadian provincial and federal government officials. It is clear, however, that views differ on the degree of consultation between Canada and the United States over replacement measures as well as on the disposition of the export tax revenues. The ambiguities implicit in the agreement are highlighted by the letter from Secretary of Commerce Baldridge to Stanley Dennison of the Coalition for Fair Lumber Imports (cited earlier in this chapter) and the negative Canadian reaction to it.[6]

Another pragmatic reason for the agreement was the view that a positive final subsidy determination by the ITA would set a serious legal precedent for all Canadian resource industries exporting to the United States. The December 30, 1986, agreement was viewed by the Canadian negotiators as terminating the countervail case. While a political precedent was set in that Canada did implicitly accept the notion that stumpage was subsidized, the agreement was between two governments on behalf of the participants; it was not the finding of a quasi-judicial trade body that could serve as a precedent in subsequent cases.

The broader issue regarding the Softwood Lumber dispute is whether Canada could have, and should have, avoided the countervail process altogether. There were clear signals that Canadian softwood lumber exports were a focus of protectionist pressures and that there was sympathy for the U.S. industry's position in Congress and in the Administration. We have already noted a number of instances which should have been interpreted as indicators of severe problems ahead for Canadian softwood lumber exports to the United States. The ITC's December 1985 revision of productivity figures – showing both a superior level and a growth rate of the Canadian industry superior to the U.S. softwood lumber industry – is an example. Even more ominous was the activity of senators and House members from timber-producing states. We have already in this chapter commented upon the role of Senator Max Baucus and upon the pressure exerted by the Senate Finance Committee over the lumber issue.

Legislative initiatives provided a strong back-up to the countervail process for the U.S. industry during the 1986 phase of the Softwood Lumber dispute. In the first session of the Ninety-ninth Congress, a variety of bills dealt specifically with resource pricing issues and have already been discussed in Chapters 2 and 3. Another

bill (H.R. 1648), introduced into the session by Congressman Bonker (Democrat, Washington), dealt specifically with stumpage and its Section 4 would expand the definition of subsidy to include "furnishing of stumpage rights on government lands by a country under a program or system in which those rights are furnished to an enterprise in exchange for compensation by that enterprise that is less than the current price for comparable stumpage rights on government lands in the United States." Even had Canada won the Softwood Lumber case before the ITC and ITA, its success probably would have provoked a legislative response that would have subjected softwood lumber exports to U.S. duty. Thus in a very real sense it appears that Canada and its softwood lumber industry were in a no-win situation once the U.S. Coalition for Fair Lumber Imports filed its countervail petition in May 1986.

A serious "problem" that really prevented much discussion of alternatives to the countervail process was the mistaken perception among Canadian observers that U.S. quasi-judicial trade bodies were insulated from political pressures and would judge the Softwood Lumber case on its economic merits. Since neither the statutory law nor the facts of the case had changed since 1983, this presumption cannot really be faulted. Yet, if one looks at the broader picture, it is clear that protectionist pressures had risen significantly in the United States since 1982 as an overvalued U.S. dollar placed more and more stress on import-sensitive domestic industries.

Alternative proposals failed to emerge to pre-empt the filing of a petition by the U.S. coalition, largely because of the position of the British Columbia government, under Premier Bennett, and the position of the Canadian Forest Industries Council, the Canadian forest industry lobby group. Both strongly believed that a new countervail case, were the U.S. industry to initiate one, could be won on its economic merits. However, once the countervail process began, and the extent of the protectionist lobby in the United States became apparent, the Canadian Forest Industries Council suggested a change of tactics. According to A.H. Zimmerman, chairman of the council:

> In an effort to maintain some order, and in recognition of the politics at work in the U.S., the Canadian lumber industry formulated Plan B in July [of 1986]. This suggested a quiet diplomacy at the highest level, in which, as a counter to some of the political pressure in the U.S., Canada might put in place some form of export tax or levy that could be funneled back to the benefit of the timber industry. (*Financial Post* 1986b)

The election of Mr. Vander Zalm to succeed Mr. Bennett as premier of British Columbia led to a change in tactics by that province and a more accommodating view regarding a negotiated settlement. For example, the new minister of forests, Jack Kempf, in early September 1986 called for a review of stumpage policies in the province. The minister is quoted as stating, "I think we need to have a look at it when an industry on which we spend $360 million a year returns only $150 million" (*Vancouver Sun* 1986b). Premier Vander Zalm's announcement of this review, combined with the statements of Forest Minister Jack Kempf regarding the value of stumpage collected, is viewed by forest industry officials as the turning point in the Softwood Lumber dispute (*Vancouver Sun* 1987). The apparent shift in position by the British Columbia government suggested a degree of flexibility that appeared to encourage U.S. industry intransigence.

In late September 1986 the minister for international trade, Pat Carney, offered to impose a 10 per cent export tax in return for termination of the countervail proceedings. In the communiqué outlining the offer, the minister states: "It is our only offer, it is done on a 'without prejudice' basis to our legal case, and it is not open to negotiation"; if the offer is rejected, the communiqué went on to state, "the countervail process will continue to its conclusion" (Canada Minister for International Trade 1986).

Thus, once the countervail process had been initiated, Canadian government and industry officials quickly became aware that the political climate made it unlikely the Softwood Lumber case would be judged on its merits and made it likely the case would therefore go against Canada. However, the case could be terminated only if the petitioners (the Coalition for Fair Lumber Imports) agreed. The obvious political success of the coalition, combined with the very visible weakening of the Canadian negotiating stance, provided little incentive for the U.S. industry to come to an early agreement. If anything, proceeding with the countervail process was clearly in their economic interest as it would increase the pressure on Canadian negotiators.[7]

Earlier in this chapter, some of the drawbacks with the export duty were discussed. Yet the problems with this duty are relatively minor in comparison with other alternatives, such as a voluntary export restraint agreement. At first glance there is considerable appeal in an agreement to restrict Canadian softwood lumber exports to the United States to some predetermined share of the U.S. market, say 25 per cent. Canada has no real foreign competitors in the U.S. market, so fear of entry by other producers is not warranted. A restraint agreement would have addressed U.S. concerns because it would have led to higher domestic prices and a larger market share.

However, a real problem with any such agreement would have been enforcing its provisions. The softwood lumber industry in Canada is highly competitive, with a large number of producers. Unlike the steel industry, where there are 13 steel producers exporting to the United States, there are thousands of small producers in softwood lumber. Moreover, any effort to negotiate about market shares and prices through trade associations would quickly have led to investigation under the Competition Act because of its implications for price determination in the domestic market. Thus, the federal and provincial governments would have had to assume an active role in allocating access to the 25 per cent of the U.S. market assumed in our hypothetical example. A reduction in the volume of timber allocated to the industry could have brought about some reduction in the Canadian market share in the United States. However, a coordinated and leading role by the major producing provinces would have been essential if this solution had been chosen.

The problem facing the Canadian governments would quickly have become one of how to allocate rights to the U.S. market among Canadian producers. The economic solution would have been for the federal government to auction off the rights among Canadian firms. Under this approach the market would determine who exported and how much. The most efficient firms would offer the highest bids and gain the right of access to the U.S. market. The drawback of this procedure, from the perspective of the federal government and certain provinces, would have been the unquestioned dominance of the British Columbia Interior industry in bidding for market share rights. It is conceivable that only the constraint of the allowable annual cut in the Interior would have prevented producers in the Coast region and in other provinces, especially New Brunswick, from being shut out almost entirely from exporting to the United States.

Another alternative to allocating access to the U.S. market under a restraint agreement would have been simply to allocate it on the basis of production or export levels in effect in December 1986, or on some average of the preceding years. The drawback of this approach would have been that it clearly removed the incentives for firms to invest in new plant and equipment and improve efficiency. This procedure, clearly, also would have worked against the interests of the British Columbia Interior forest products industry. Moreover, even if a plan could have been negotiated to allocate, by region, access to the U.S. market, the problem of allocating this quota among firms without a bidding mechanism would have raised serious issues regarding economic efficiency, and possibly charges of political favouritism.

Thus, as a short-run solution, the imposition of an export tax has one fundamental, attractive feature relative to other schemes – it is

neutral with respect to firm location in Canada. Although it depresses producer prices in Canada, it does so in a neutral fashion across regions. Voluntary export restraint programs, in the absence of a bidding mechanism, have the potential to allow politics rather than economic considerations to determine the location of production of softwood lumber in Canada for export to the United States.

Another solution for Canada would have been to pre-empt the countervail process by having the provinces review their stumpage policies and rectify any apparent shortcomings. The problem with this approach is that it assumes that provincial stumpage pricing policies do fail to capture the market value of timber and that this failure leads to injury of U.S. producers. These issues are at the crux of the debate; a review of the evidence in Chapter 2 suggests that market forces, far more than provincial stumpage policies, account for the rise in Canada's share of the U.S. market. Thus, a review of provincial policies with the sole intent of raising stumpage prices to a level satisfactory to the U.S. industry would have had the same impact on the Canadian industry as an export tax. Also, any arbitrary increase in timber prices would affect all industries that use Crown timber and all forest products exports, not just softwood lumber exports to the United States.

A final scenario would have been to fight the Softwood Lumber dispute on two fronts. The Canadian case – that the U.S. action constituted unfair trade harassment and an infringement of Canadian sovereignty over resource pricing – would have been pursued vigorously. The first front would have been to proceed with the countervail process in the United States while recognizing the essentially political, rather than economic, aspect of the proceedings. This element of the strategy might have involved the Canadian government in raising the political ante. It could have been made clear that U.S. actions gave rise to grave concerns because of their serious implications for a range of Canadian resource industries and these industries' competitiveness in U.S. markets. The issue could have been phrased in terms of the United States as a reliable trading partner. A resolution of the Softwood Lumber dispute, or at least an agreement defining the notion of subsidy in the case of Crown-owned natural resources, could have been made a condition for proceeding with free trade discussions with the United States or, at the very least, made an integral part of the negotiating process.

The second element of the strategy would have been to pursue a complaint before the GATT Council concerning the U.S. countervail proceedings against Canadian softwood lumber. The GATT route, however, is not like a typical appeal process. Bringing the matter before the GATT Council would not be like taking a decision of the British Columbia Court of Appeal to the Supreme Court of Canada. It

would be a substantially different kind of process. The net result of such a process would not be a verdict that the DOC's decision as to subsidies was right or wrong. Nor could the process lead to the United States being legally compelled to revoke its countervailing duty on softwood lumber. At best Canada might be able to take GATT-sanctioned retaliation against the United States.

The costs of this strategy probably would have been high and inequitably distributed. It is most likely that the final determinations by the ITA and ITC would have gone against Canada and that a 15 per cent duty would have been imposed. British Columbia would have borne the burden of the duty and the U.S. Treasury would have captured an additional $500 to $600 million (Canadian dollars) in additional revenues. The proceeding in the GATT Council could easily have stretched over two or three years; it could have resulted, perhaps, in a moral victory for Canada but there would have been little in the way of tangible compensation. Flawed as it is, the December 30, 1986, agreement was as good as any result that might have been achieved.

In fact, it has been argued that Canada is actually a net gainer as a result of the agreement. For example, Kalt (1987, 27) suggests that Canada will benefit to the amount of $117.6 million (Cdn.) per year under the agreement. The Canadian export duty raises U.S. softwood lumber prices because of the large share of the market held by Canadian imports and the relatively inelastic U.S. demand for softwood lumber. Although the export duty causes Canadian softwood lumber producer prices to fall, the net loss to the industry is less than the gain to the Canadian treasury from export tax revenues. The redistribution of income from American consumers to the Canadian treasury more than offsets the negative impact of the export tax on the Canadian industry. The agreement from this perspective permits Canada to exploit its market power in the United States.[8]

Notes

1. Studies by Baldwin (1984; 1985) and Destler (1986) are among the most recent contributions. The studies of Pincus (1975; 1977) and Caves (1976) are other examples of econometric efforts to link the pattern of tariffs to structural characteristics of industry and the economy.

2. Only in two kinds of cases will tariffs possibly improve the overall economic well-being of residents of a country – an optimal tariff where the positive effects on terms of trade outweigh its efficiency costs, or the example of an "infant" industry.

3. Chen (1974) found that the United States reduced tariff rates the least in industries characterized by the highest adjustment costs for labour, and these costs themselves varied with the extent of unskilled labour.

4. Studies by Martinello (1985), for Canada, and Steir (1980; 1983), for the United States, find evidence of labour-saving technological change.

5. The research director of the International Woodworkers of America (IWA) has argued that the export tax will have little impact because of the high level of efficiency of Canadian mills. His report predicts that the tax will lead to the loss of about 1,000 jobs, and have little impact on either lumber exports or industry profits (*Globe and Mail* 1987b). The IWA view has been disputed by industry representatives who claim the report ignores regional productivity differences and the cyclical nature of the market (*Globe and Mail* 1987c).

6. Canada sent a diplomatic protest to the U.S. government over Secretary Baldridge's letter to the Coalition for Fair Lumber Imports regarding the December 30, 1986, agreement. It appears, however, that the Administration stands by the contents of the letter (*Globe and Mail* 1987g).

7. The lack of cohesion displayed by the provinces, federal government, and industry in the negotiations after August 1986 cannot but have hurt Canada's chances before the ITA subsidy determination. In his excellent review of the lessons of the 1982 Softwood Lumber dispute, Jansen (1984) emphasized the need for a unified stand in the countervail process.

8. The evidence provided by Boyd and Krutilla (1987, 29) also suggests a net Canadian gain under the agreement. Boyd and Krutilla (1987) do not specifically assess the case where Canada captures the tariff revenue. But if we assume that their estimate of U.S. treasury gains instead accrues to the Canadian treasury, then it more than offsets the Canadian export welfare loss borne by the Canadian softwood lumber industry. Their results also show Canada being a net gainer from a voluntary export restraint agreement.

Chapter 6:

Conclusions

This study has examined the 1986 phase of the Softwood Lumber dispute between Canada and the United States. The basic issue is whether the increase in the Canadian share of the U.S. market was the outcome of market forces or the result of timber-pricing policies by the provinces. The available evidence regarding relative productivity levels and their growth, and movements in real exchange rates, supports the view that market forces played the major role in increasing Canadian softwood lumber exports to the United States. While Canadian timber may be "underpriced" in the sense that not all of the resource rents may be captured by the Crown, the magnitude of any "leakage" is apparently not of the magnitude alleged by the U.S. Coalition for Fair Lumber Imports (32 per cent) nor is it certain that U.S. producers have been harmed as a result.

In the case of British Columbia, the evidence of alleged "underpricing" of standing timber in comparison with comparable areas of the United States is quite misleading. Differences in transportation costs, in quality and species mix, and in the financial obligations of various forms of tenure account for much of the observed disparity in stumpage prices between the Pacific Northwest and British Columbia. There are two important institutional determinants of the timber supply available to the industry – the annual allowable cut set by the Ministry of Forests of British Columbia, and requirements that the actual harvest be within 10 per cent of the annual allowable cut. Therefore, if the annual allowable cut was a binding constraint on the harvest, a failure to capture fully

the market price of timber would simply increase forest industry profits and leave the volume of timber production unchanged. The economic issues involved in the dispute are complex, and the real issues at stake were obscured by the simple comparisons of stumpage prices which characterized much of the reporting of the dispute. It is very clear that far more research must be undertaken before the link between Crown stumpage policies and the volume of lumber exports is known in detail.

The Memorandum of Understanding of December 30, 1986, under which Canada imposed a 15 per cent duty on softwood lumber exports to the United States, can be seen as a salvage operation. The intent was to ensure that the revenue from any duty imposed remained in Canada, and to attempt to prevent a legal precedent that could have been applied to other Canadian resource industries. However, it is ironic that recent protectionist legislation, such as H.R. 3, passed by the 100th Congress draws directly from the preliminary, affirmative countervailing-duty decision of the International Trade Administration (ITA). Moreover, the political precedent – of compromising with the protectionist efforts of a U.S. industry lobby group – remains.

The Rise of Protectionism in the United States

Two closely related factors led the 1986 phase of the dispute to differ in outcome from the earlier 1982-1983 action. First, the financing of the huge U.S. government budget deficit has induced large foreign capital inflows into the United States and an appreciation of the U.S. dollar; this has led to a massive deficit on merchandise trade for the United States, as the volume of imports has increased while export volumes have stagnated. Import penetration across the spectrum of U.S. industry has occurred, with softwood lumber being only one example.

The second major factor, and one which stems directly from the first, is that protectionist sentiment has increased significantly in the United States. The U.S. Congress has attempted to address the failure of U.S. fiscal policy and its impact on trade by treating the symptom – the trade deficit – rather than the cause – the government budget deficit. Through various trade bills and their emphasis on retaliation and reciprocity, the Congress is attempting to have the United States' major trading partners accommodate U.S. trade problems that are domestically generated. The rise in protectionist sentiment has provided import-sensitive industries with a perfect opportunity to argue for contingent protection. The rise in the Canadian share of the U.S. softwood lumber market (to approximately 31 per cent by 1986) made Canada softwood lumber a highly visible

target for protectionist forces. This visibility, combined with the political efforts of senators from timber-producing states in the Pacific Northwest, made it unlikely that Canada could prevail in the countervail process. Certainly the flawed and *ad hoc* reasoning underlying the preliminary determination of subsidy by the ITA on October 16, 1986, suggested a significant change in the "rules of the game" since the 1982 case. The legal interpretation of and the economic concepts underlying current U.S. trade law have been stretched to such an extent that the legitimacy of the entire process can be questioned.

The efforts of Congress to provide greater protection to U.S. industry through more stringent trade legislation can be viewed as indicative of a failure of political will and as inconsistent with respect to the role of the United States as a leading proponent of free trade. Much of the current U.S. trade deficit arises from the consequences of the budget deficit and its effect on the value of the U.S. dollar. Efforts on the part of Congress to restrict imports, or to create the atmosphere in which quasi-judicial trade agencies feel that they must erect trade barriers, represent an attempt to shift onto the rest of the world the burden of adjustment to poor U.S. fiscal policies. The obvious alternative for Congress and the executive branch is to reduce the size of the U.S. budget deficit. Unfortunately, the net political gains from protection are perceived to outweigh the net benefits of a more sensible economic strategy.

The Outlook for Resource Industries

Although the relevant statutory trade-remedy laws have not as yet changed since the 1982-1983 case, the interpretation of them adopted by the Department of Commerce has evolved. Arguably, they allow sufficient flexibility that virtually any exercise of discretion by a provincial government in the allocation of a Crown-owned resource provides grounds for the finding of preferentiality. The United States is becoming an increasingly high-cost producer of resource products. One can predict, on the basis of the Softwood Lumber dispute, the emergence of a formidable array of trade barriers protecting the resources sector and an increased willingness on the part of U.S. producers to take advantage of these barriers. Certainly in the near term, the pulp and paper industry of Canada may be subject to countervail proceedings in light of the ITA finding (in its October 16, 1986 determination in the Softwood Lumber case) that Crown timber was subsidized.

In many cases, the justification for such protection will be based on differences in resource prices between the United States and its foreign competitors, even though these differences may reflect market

forces rather than government policies. With respect to trade in natural resources, U.S. trade policy will be directed more and more at offsetting the comparative advantage of foreign producers arising from the quality and quantity of resource endowments, from greater productivity or from other market conditions. It is quite likely that the most contentious trade issues in the next decade will derive from U.S. efforts to protect domestic resource producers through redefining the notion of comparative advantage to the benefit of U.S. producers. For Canadian resource industries this means that U.S. regulatory agencies may take a more active role in restraining Canadian resource exports. The decision by the Federal Energy Regulatory Commission to disallow Canadian natural gas pricing practices is one example. Hydroelectric exports to the United States may also run into regulatory problems, as coal producers and competing utilities in the United States attempt to erect stumbling blocks to additional Canadian electricity exports.

The Consequences for Canadian Trade Policies

In the aftermath of what can only be described as a disappointing if unavoidable defeat in the Softwood Lumber dispute, Canadian resource industry officials and government policy-makers must assess once more the long-term implications of doing business with the United States. This reassessment should now, if it did not before, take into account several well-established reference points. First, U.S. trade policy is not anchored in objective economic analysis. Canadians should not waste their energies debating whether their programs amount to subsidies in accordance with economic principles unless both countries can agree on the economic principles they will adhere to in determining subsidy. Second, the quasi-judicial process of resolving trade disputes, which ostensibly gave Canadian industry their day in court during the investigating phase of the trade dispute, should not be assumed to be impartial and immune to political considerations. In other words, sound economic and legal arguments do not necessarily guarantee Canadian industry unimpeded access to the U.S. market. Rather than relying on such arguments, it would seem sensible to adopt the view that legal harassment is a long-term cost of doing business in the United States and that the energies of Canadian industry and government officials should be devoted to coping with, and minimizing if possible, these long-term costs. If any Canadian industry is interested in increasing its market share in the United States, it should build into its long-term business plan a method of handling the costs associated with fighting protectionist measures.

There are a range of possibilities in this area, extending from government initiatives to actions that could be developed by private industry. A fundamental principle that should be foremost in any long-term trade strategy should be the effective monitoring of the U.S. market. If the Canadian share of a given market is significantly expanding, an industry should consider either voluntarily curtailing the expansion or preparing to mount a defence against the inevitable protectionist backlash. It may be that "making hay while the sun shines" will be the choice; it could be that the eventual costs of a battle against protectionism will be more than covered by maximizing profits during the market expansion phase. On the other hand, if a given U.S. industry has a strong political base, it may be wise to curb market expansion voluntarily and to concentrate on communicating with U.S. officials about market share. Whatever the facts of a given case might be, the underlying principle should remain the same: long-term unimpeded expansion of access to U.S. markets is not guaranteed, even if the expansion is market-based and unrelated to subsidy.

Impediments to market access may be removed in two general ways—by negotiations between governments and by intelligent private planning. Both require an element of dedication and long-term commitment. Canada is currently undertaking extensive trade negotiations at both the General Agreement on Tariffs and Trade (GATT) and bilateral levels. It would seem sensible for Canadian resource industries to support these efforts and to do so with vigour. The cost of pushing the government to reduce impediments to trade should be seen as a long-term investment. Industries should coordinate their efforts and exert maximum pressure at the best points in the process.

The Implications of the Softwood Lumber Dispute for Free Trade Negotiations

The Softwood Lumber dispute and its resolution have two basic implications for Canada-U.S. free trade negotiations. The first is that the term "free trade" is a complete misnomer for the process. Canada and the United States have for some time been embarking on a course of "managed" trade. This process has been accomplished by the application of U.S. contingent-protection laws and through the efforts of Canadian industries to avoid their application. It is clear that once a Canadian industry increases its market share in the United States, the formidable array of U.S. contingent-protection mechanisms will be brought to bear on it. As noted earlier, the definitions of "subsidy" and "injury" employed by quasi-judicial trade bodies have become sufficiently flexible that they can accommodate virtually any petition

initiated by U.S. industry groups. Canadian industries are thus very aware that continued access to the U.S. market depends critically on not exceeding some implicit or explicit market share. The example of the steel industry is a case in point. That market forces are responsible for shifts in market share does not appear to be a sustainable defence before the International Trade Commission (ITC) and the ITA, at least in politically visible cases such as softwood lumber.

The second implication of the Softwood Lumber dispute is that any free trade agreement with the U.S. must include provisions for a trade-dispute tribunal that supersedes the application of United States contingent protection. In the absence of such a body, if a free trade agreement were negotiated and Canadian firms took advantage of unhindered access to the U.S. market, it is highly likely that U.S. industry groups would respond with an onslaught of suits under the "Escape Clause" (Section 201) or market disruption provisions, unfair government trading practices, or countervail proceedings. The potential gains to Canadian firms from access to the United States would not be realized or would be dissipated in legal actions before U.S. trade bodies. The cost of the current Softwood Lumber dispute to the Canadian industry – just for legal and consulting fees – has been estimated at about $11 million. These costs do not include time costs of senior management or those of officials of federal and provincial governments involved in the dispute. At present, U.S. trade remedies are applied in order to harass Canadian exporters; certainly this would occur with even greater frequency in a free trade agreement with no provisions for a mechanism to settle disputes.

Yet even the creation of a trade-dispute tribunal may not solve the problem of the application of U.S. contingent trade remedies. Any such tribunal would ultimately be subject to political pressures from both Canadian and U.S. governments, reflecting domestic political realities. A trade-dispute tribunal might serve as a screen against suits undertaken simply as obvious trade harassment by industries in either country. But the underlying reality – the responsiveness of the political process to protectionist pressures, which is the heart of the problem – will remain.

A point raised in the Introduction deserves to be repeated. The basic objective of contingent trade remedies is to protect domestic producers from foreign competition that is unfair or injurious. But from the perspective of any beleaguered industry all competition tends to be unfair and injurious, whether it stems from true (market-based) cost advantages or from subsidy. Thus, we should not be too surprised when domestic firms subject to increasingly high levels of import competition take recourse to available trade remedies. Nor should we be surprised, when the existing legislative framework or its

interpretation proves unsatisfactory in addressing the needs of domestic producers, that pressures build for its revision. What is surprising is that the Canadian industry and governments in the Softwood Lumber dispute actually believed that the U.S. quasi-judicial approach to contingent protection was devoid of such pressures.

The Issue of Natural Resource Subsidies

The question of natural resource subsidies is an issue that must be addressed in free trade negotiations. Failure to do so will mean that the resource industries of Canada will find it increasingly difficult to maintain access to the U.S. market. The basic objective of any such negotiations should be to ensure that the notion of comparative advantage is somehow recognized in any agreement on the topic. Yet achieving this objective will be very difficult. Resource endowments do differ between countries (and regions), as do the market-determined unit costs of extraction, processing, and access to markets. Such differences will be reflected in differential resource prices on site (see, for example, Table 3.4) as the return to the resource base is a residual return after all costs have been taken into account.

Current approaches to the interpretation of natural resource subsidies, especially those embodied in bills passed in the 100th Congress (such as H.R. 3), fail to recognize why resource prices differ so markedly between regions and countries. For example, the use of external (i.e., U.S.) benchmarks to value Canadian resources on site is totally inappropriate and thus far, to its credit, the ITA has withstood enormous pressure to adopt this criterion for evaluating natural resource subsidies. The problem with the external benchmark criterion is that it negates any comparative advantage derived from natural resource endowments (quantity and quality) and lower (market) cost structures. Again, at the risk of repetition, it must be emphasized that so many factors differ between countries (and regions) that simple cross-border comparisons of resource prices are bound to be misleading. Politically, however, such a criterion would be very appealing, as it would automatically shield high-cost domestic producers in the United States from external competition.

The use of a "government cost of production" criterion, such as employed in the ITA's 1986 preliminary Softwood Lumber determination, is another route to be avoided even if the "double counting" error contained in that decision is ignored. The cost of production is a nebulous concept at best, especially when dealing with natural resources such as old-growth timber or the commercial fishery. Moreover, adoption of this criterion ignores completely the issue of whether the resource-pricing mechanism under consideration

captures the full value of the economic resource. The so-called "government costs of production" might be recovered, but rents might remain uncaptured by the government. Moreover, many expenditures by government in the resource base are in the nature of long-term investments, with a pay-off decades away. Under these circumstances these investments should *not* be seen as a charge against the value of current resources being extracted.

Furthermore, resource industries face highly volatile demands, and therefore returns to the forest base tend to fluctuate dramatically over time. Yet in some cases costs in these industries are relatively unresponsive with respect to the resources price cycle. In the case of mining, for example, most costs are fixed costs because of the large capital expenditure associated with projects in this industry. Or in the case of forestry, expenditures on forest management, including activities such as forest fire prevention, are relatively invariant to timber prices. Thus, in years of poor demand for wood products, Crown expenditures on preserving the commercial timber crop may exceed stumpage revenues. Yet over the entire price cycle, net returns to the forest base may be very large and may exceed Crown expenditures. Thus cyclical factors are highly important when trying to evaluate Crown "cost of production" expenditures in relation to revenues from the resource base.

The most productive way of addressing the concept of natural resource subsidies in the free trade discussions is to focus on the pricing mechanisms employed in valuing the resource base. Do these mechanisms capture the market value of the resource? In the case of Canada, a combination of Crown ownership and the potential for market failure in the resources sector has led, in many instances, to the use of administrative pricing mechanisms rather than direct market-based values.

The focus of any debate must be whether these administrative pricing mechanisms reflect, insofar as is possible, the market's valuation of the resource. A shift from Crown ownership to private ownership is not a realistic option to achieve this goal. Canada has a history of Crown ownership and regulation of the natural resource industries. This history reflects the importance of these sectors to Canadian economic development at the national and regional levels, and it also reflects a different perspective in Canada on the role of government. Since resource management policies are so important to many Canadians, it is highly unlikely that the dominant role of the Crown as resource owner and manager will change, especially in response to pressures from the free trade discussions.

The ideal solution would be to assign the dispute-solving tribunal between Canada and the United States the responsibility for evaluating whether administratively determined pricing mechanisms

are capable of capturing fully the economic returns to the resource base. This approach would focus directly on the issue of resource pricing and would avoid reliance on external benchmarks or cost-of-production criteria.

Such a tribunal would have to accept, however, that policies affecting the disposition and pricing of Crown resources are inextricably linked to the issue of sovereignty. The exercise of government discretion, to correct market failure, for example, or to achieve non-market objectives deemed desirable by society, represents a legitimate function assigned to government by society. As such, different national attitudes regarding the role of government in society are embodied in the mandate given a government by its citizens. Canadian perceptions of the role of government do differ from those of Americans. The resources sector plays a critical role in the national and regional economies in maintaining economic growth and employment. The notion of a "level playing field" must somehow reconcile differing perspectives on the role of government and on the importance of certain key sectors to each country.

The rise in protectionism in the United States may again bring to the fore the notion that there is a "price" to being Canadian. Now the debate will shift from discussing the national and regional incidence of tariff and transportation policies (for example, the "National Policy") to assessing the national and regional consequences in Canada of U.S. protectionism.

Appendix A:

A Chronology of the Softwood Lumber Dispute, 1982 to December 30, 1986

DATE
(Mo./Day/Yr.)

Countervailing Duty (CVD) I
Lumber, Shingles and Shakes, Fence

10/07/82 - Lumber, Shingles and Shakes, Fence CVD petition filed by U.S. Coalition for Fair Canadian Lumber Imports (CFCLI).

11/17/82 - International Trade Commission (ITC) preliminary affirmative injury determination.

03/07/83 - International Trade Administration (ITA) of Department of Commerce preliminary negative determination.

03/21/83 - CFCLI appeals DOC preliminary negative determination to Court of International Trade (CIT).

04/12/83 - CFCLI appeal dismissed by CIT.

05/31/83 - DOC (ITA) final negative determination (case terminated). CFCLI does not exercise right of appeal to CIT.

02/07/85 - H.R. 1088 introduced by Weaver (D-Oreg.) to impose five-year restriction on lumber imports at 25 per cent (later 20 per cent) of U.S. market.

02/19/85 - H.R. 1139 introduced by Schulze (R-Pa.) to impose 20 per cent duty on all imports from countries restricting trade.

02/26/85 - Canada-U.S. government meeting in Ottawa re lumber .

04/03/85 - H.R. 1950 introduced by Guarini (D-N.J.) (later replaced by H.R. 3777). Labor Industry Coalition on International Trade (LICIT) bill containing natural resource subsidy provision.

04/23/85 - S. 982 introduced by Baucus (D-Mont.) Senate version of H.R. 1648.

04/24/85 - Canada-U.S. government meeting in Washington re lumber.

05/02/85 - H. Con. Res. 136 introduced by McKernan (R-Maine) Requests president to pursue negotiations with Canada on trade issues (including wood products).

- H.R. 2345 introduced by Moore (R-La.) to impose CVD against foreign natural resource subsidies; removal rights not included.

05/03/85 - Canadian Forest Industries Council (CFIC) four-volume submission to ITC in Sec. 332 investigation (including updated cross-border studies, marketing study, etc.).

05/09/85 - H.R. 2451 introduced by Gibbons (D-Fla.); natural resource subsidy bill including removal rights.

05/15/85 - S. 960 (Foreign Assistance Act) passed Senate with Symms (R-Idaho) amendment stating that U.S. president should pursue discussion with Canadian government to reduce lumber exports to the U.S.

05/24/85 - S. 1224 introduced by McClure (R-Idaho). Senate version of H.R. 1088.

05/31/85 - ITC initiates update of Sec. 332 investigation of lumber.

06/06/85 - House Ways and Means Trade Sub-Committee hearing on H.R. 2451 (Gibbons natural resource subsidy bill).

06/13/85 - S. 1292 introduced by Baucus (D-Mont.). Senate version of H.R. 2451.

06/25/85 - S. 1356 introduced by Heinz (R-Pa.). Senate version of H.R. 1950.

- Timber Summit I in Washington: 50 senators and congressmen meet with U.S. Administration officials, including Baldridge, on lumber. Baldridge states that Administration does not support Gibbons bill.

08/01/85 - S. 1576 introduced by Mitchell (D-Maine) to set up a joint commission to resolve U.S.-Canada trade disputes.

- S. 960 with Symms (R-Idaho) amendment passed by Congress. Signed by president on 08/08/85.

09/23/85 - U.S. shakes and shingles industry submits petition for relief under Sec. 201. CFIC commences legal defence.

10/01/85 - Ten senators send letter to Yeutter re early resolution of lumber issue.

- Gibbons (D-Fla.) proposes revised language for H.R. 2451.

10/09/85 - ITC issues Sec. 332 report on lumber to the president.

10/17/85 - H. J. Res . 458 introduced by Schulze (R-Pa.). Resolution in support of U.S.-Canada entering negotiations for free trade agreement.

10/24/85 - Ways and Means Trade Sub-Committee markup of Gibbons bill H.R. 2451. Amendment to delete removal rights aspects defeated by 5-4 vote.

11/15/85 - Sixty-four congressmen sign letter to Sec. of State Shultz – resolve lumber issue before free trade agreement talks (FTA).

11/19/85 - H.R. 3777 introduced by Dingell (D-Mich.) and Broyhill (R-N.C.). Omnibus trade bill of Energy and Commerce Committee with unfair natural resource pricing and removal rights under Sec. 301.

11/20/85 - S. 1860 introduced by Danforth (R-Mo.); Senate trade bill; no natural resource subsidy provision.

12/18/85 - S. 1977 introduced by Symms (R-Idaho), McClure (R-Idaho) to impose three-year tariff on lumber, shakes and shingles.

12/26/85 - ITC supplement to Sec. 332 report on lumber issue.

01/09/86 - ITC hearing in Washington re Sec. 201 investigation of shakes and shingles.

01/30/86 - S. 2033 introduced by Chiles (D-Fla.); Democratic leadership council trade bill with natural resource subsidy provision.

- H.R. 4093 introduced by Mica (D-Fla.). House version of S. 2033.

02/06/86 - H.R. 4159 introduced by Weaver (D-Oreg.) re restricting U.S./state log exports.

02/26/86 - Senate Special Order Session – Baucus (D-Mont.) vows to fight fast-track approval for FTA until lumber is resolved.

- ITC vote (4-2) finds injury in Sec. 201 shakes and shingles case.

03/05/86 - House of Representatives Special Order Session led by Craig (R-Idaho).

03/18/86 - ITC commissioners vote on remedy recommendation in Sec. 201 shakes and shingles case: three for 35 per cent tariff, two for adjustment assistance, and one for no relief.

03/20/86 - Timber Summit II in Washington: approximately 20 congressmen and senators meet with Baldridge, Yeutter, Woods, and Smart.

03/25/86 - Written ITC Report to the president on shakes and shingles Sec. 201 investigation, with three of six commissioners recommending 35 per cent tariff for five years.

04/11/86 - Senate Finance Committee hearing on proposed Canada-U.S. free trade negotiations. At least half of committee members indicate opposition to fast track.

04/17/86 - Yeutter letter to Pryor (D-Ark.) re fast-track approval for FTA – "We'll get lumber fixed."

04/22/86 - Reagan letter to Symms (R-Idaho) re progress on lumber before conclusion of FTA.

04/23/86 - Tie vote 10-10 in Senate Finance committee allows fast-track FTA negotiations to proceed.

04/30/86 - House Ways and Means Committee mark-up of Gibbons bill (H.R. 2451). Amendment by Jacobs (D-Ind.) on natural resource subsidy defeated by 12-12 vote.

05/05/86 - CFCLI decides to file CVD case on lumber.

05/09/86 - H.R. 4800, House omnibus trade bill introduced by Wright (D-Tex.) (incl. 2451 and 2324); includes natural resource subsidy provision.

05/12/86 - Filing of lumber CVD petition held off one week at request of Canada to study possibility of resolution through "envoy" approach.

05/14/86 - Nine U.S. cabinet members send letter to House expressing reservations on H.R. 4800, including reservations about natural resource subsidy provision.

05/19/86 - Lumber CVD petition filed by Coalition for Fair Lumber Imports requesting 27 per cent duty.

05/22/86 - H.R. 4800 passed by House.

05/23/86 - President imposes 35 per cent tariff on Western Red Cedar shakes and shingles.

06/02/86 - Canada announces retaliation package as a result of shake and shingle decision.

06/04/86 - Letter on behalf of CFIC to Baldridge urging rejection of CVD petition.

06/05/86 - DOC initiates CVD investigation.

06/10/86 - ITC preliminary injury hearing.

06/12/86 - U.S. Federal Trade Commission files brief with ITC stating that Canadian stumpage programs are not subsidized and do not injure U.S. lumber industry.

06/17/86 - Canadian government statement to GATT Council re second lumber CVD case considered to be harassment.

06/26/86 - ITC preliminary determination on injury is affirmative.

- Canadian government requests conciliation under Article 17 of the GATT code.

06/30/86 - DOC (ITA) finds lumber CVD case to be extraordinarily complicated and postpones date of preliminary determination.

08/01/86 - Second GATT conciliation meeting held.

06/08/86 - Vander Zalm sworn in as premier of British Columbia.

09/04/86 - Minister Kempf announces immediate review of B.C.'s forest management policies.

09/08/86 - Minister Carney, at request of Premier Vander Zalm, makes request of Baldridge for postponement of October 9 deadline for preliminary determination on subsidy by Commerce, as early determination could affect B.C.'s own internal review of forest management policies. [Secretary Baldridge acting under statutory deadlines which precluded CVD postponement beyond October 16, 1986.]

09/09/86 - CFCLI petitioners brief requests CVD of 32 per cent.

09/10/86 - CFIC stumpage brief with experts' reports filed with DOC (ITA).

09/26/86 - CFCLI petitioners brief requests CVD of 33-36 per cent.

09/30/86 - Canadian federal government makes final stumpage offer of 10 per cent dollar equivalent based on four provinces raising stumpage rates by aggregate amount of ±$370 million annually. Minister Carney says: "It is our only offer, it is done on a 'without prejudice' basis to our legal case and is not open to negotiation." Also states export tax would be unfair. U.S. initial response: "Good opening offer."

10/02/86 - U.S. industry rejects offer made Sept. 30. "The amount of the Canadian offer is still far too low, the changes won't be implemented for some time and, lastly, we don't have the necessary details of how the proposal could actually work."

10/07/86 - Bonker (D-Wash.) plus 36 other members of Congress write to Yeutter re CVD, stating "failure to resolve the softwood lumber problem through established administrative

procedure will only increase the pressure for a legislative resolution."

10/16/86 - DOC (ITA) issues affirmative preliminary determination on lumber – 15 per cent.

10/20/86 - DOC (ITA) disclosure conference on preliminary CVD determination.

10/27/86 - ITA verification process begins. Federal, provincial, industry meeting with DOC (ITA) investigators in Ottawa.

10/30/86 - Minister Carney sends letter to Secretary Baldridge stating, "The methodology used to determine that stumpage is provided at preferential rates is simply wrong."

11/05/86 - ITC notification of initiation of final lumber CVD injury investigation published in Federal Register.

11/17/86 - Federal, provincial deputy ministers meeting in Ottawa. B.C. pushing for suspension agreement.

11/18/86 - Federal, provincial ministers meeting in Ottawa. Agreement that Canada should fight on all fronts.

11/19/86 - Minister Kempf announces that B.C. government has been given legal advice that it can cut its own deal with the U.S.

- Minister Carney proposes to Secretary Baldridge a settlement based on 15 per cent.

11/20/86 - CFIC sends telex to Prime Minister Mulroney at First Ministers meeting in Vancouver urging continued fight.

- Minister Carney presents settlement said to have been worked out with Baldridge to First Ministers meeting. Offer of 15 per cent export tax for withdrawal of the petition. No prior consultation with industry.

11/26/86 - CFIC pre-hearing briefs filed with DOC (ITA).

11/27/86 - Premier Vander Zalm withdraws threat to seek independent deal with U.S.

11/28/86 - Deadline for draft suspension agreement.

12/05/86 - Coalition for Fair Lumber Imports issues statement which does not accept or reject Canadian offer.

12/09/86 - U.S.-Canada detailed negotiations on settlement commence.

12/10/86 - Carney says U.S. proposal is "unacceptable" and cannot form a basis for discussion. Canada's proposal is "still on the table."

12/11/86 - Indications that Coalition for Fair Lumber Imports accepts 15 per cent level of export tax.

12/12/86 - Third and last day of presentation by Canada and U.S. to GATT panel on lumber case.

12/16/86 and 12/17/86 - Canada-U.S. lumber talks in Washington. No agreement reached. U.S. puts forward counter-proposal but accepts 15 per cent export tax as base.

12/18/86 - Minister Carney rejects U.S. counter-offer as "unreasonable."

12/23/86 - ITC pre-hearing staff report placed in the public record.

12/29/86 and 12/30/86 - Canada-U.S. lumber talks in Washington. Negotiated settlement reached and signed shortly before midnight deadline for issuance of final CVD determination by DOC (ITA) - 15 per cent export tax; petition is withdrawn.

1985/86 - CFIC's legal and consulting fees for 1985 and 1986 re legislation, shingles and shakes, and lumber CVD II total $10.6 million.

02/05/87 - S. 490 introduced by Bentsen (D-Tex.) et al. Senate omnibus trade bill without natural resource subsidy provision.

02/19/87 - U.S. Administration introduces Trade Competitiveness Act of 1987. No natural resource subsidy provision.

- Canada ends tariff retaliation measures related to shakes and shingles case but not including cedar log export ban to U.S.

03/09/87 - Federal/provincial forestry ministers meeting in Toronto to review status on conversion of export tax process. CFIC

and Canadian Paper Producers Association (CPPA) make presentations advocating no conversion.

03/10/87 - CFIC meeting in Ottawa.

Prepared by CFIC Vancouver
March 9, 1987

Appendix B:

Memorandum of Understanding

1. The Governments of Canada and the United States of America enter into this Understanding to resolve differences with respect to the conditions affecting trade in softwood lumber products.

2. DEFINITIONS

For purposes of this Understanding, the following definitions apply:

a. CERTAIN SOFTWOOD LUMBER PRODUCTS - means those products identified in Appendix A, except as modified by agreement between the Government of Canada and the Government of the United States of America. The Tariff Schedules of the United States Annotated (TSUSA) number as it stands at the time of the entry into force of the Understanding controls the definition of each covered product.

b. UNITED STATES OF AMERICA - means the customs territory of the United States of America and foreign trade zones located in the territory of the United States of America.

3. GENERAL PROVISIONS

a. Both Governments agree that the time of this Understanding will be implemented when the countervailing duty petition on certain softwood lumber

products from Canada is withdrawn and the notice of termination of the investigation is signed.

b. This Understanding is without prejudice to the position of either Government as to whether the stumpage programs and practices of Canadian governments constitute subsidies under United States law or any international agreement.

c. The Government of the United States of America will release bonds and refund deposits made pursuant to the preliminary affirmative countervailing duty determination on softwood lumber products from Canada.

d. The Government of the United States of America will state in the notice of termination that the preliminary affirmative countervailing duty determination on certain softwood lumber products from Canada is henceforth without legal force and effect.

4. EXPORT CHARGE

a. The Government of Canada will collect an export charge on exports of certain softwood lumber products made on or after January 8, 1987, directly or indirectly from Canada to the United States of America. Exports to countries other than the United States which are in transit to the United States of America will be treated as exports to the United States of America. Exports from Canada which are in transit to the United States of America on a through bill of lading dated on or before December 30, 1986 will not be subject to an export charge.

b. Unless the export charge is modified under the provisions of paragraph 5, the charge will be equal to 15 percent *ad valorem* of the f.o.b. final mill price of the exported product. The export charge however will not be imposed on the value added in manufacturing some softwood lumber products. The Government of Canada will collect an export charge on those products listed in Appendix B and such other further manufactured products as may subsequently be agreed to by the two Governments. The export charge for these products will be 15 percent of the certified value of the softwood lumber imports used in their manufacture. For purposes of determining the value of such imports for non-arm's length transactions the appropriate value will be established by utilizing the values of either identical, or if that value cannot be determined, similar products which have been sold on an arm's length basis.

c. For the purpose of collecting the export charge, all exporters will be required to obtain a license from the Department of

National Revenue. Export charges will be collected no later than the last day of the first month following that in which the products were exported. Certain softwood lumber products which include products listed in Appendix B will be placed on the Canadian Export Control List to facilitate enforcement. Export of these products will be permitted under a General Export Permit which will require that all shipments be made in compliance with the provisions of the Softwood Lumber Products Export Charge Act and its accompanying Regulations. An "Export Notice" will be required for each shipment and will identify *inter alia* the exporter's license number, the General Export Permit number, the product exported, and the quantity and the sales price of the product exported. If the charge is to be paid on some value other than the sales price of the product exported, the export notice also will identify to the extent known by the exporter, the product on which the charge is to be levied, its unit price, and the value on which the charge is to be based. A copy of this Notice must be presented to Canada Customs at the time of export, with two additional copies available to U.S. Customs.

d. The companies listed in Appendix C are exempt from payment of the export charge in respect of their own production of certain softwood lumber products if the Government of Canada certifies every six months to the Government of the United States of America that they are harvesting no timber from Crown lands in Alberta, British Columbia, Ontario, or Quebec.

e. The Government of Canada will take all reasonable steps to prevent circumvention or avoidance of the payment of the export charge determined in accordance with this Understanding.

5. REPLACEMENT MEASURES

a. The Government of Canada may reduce or eliminate the export charge on the basis of increased stumpage or other charges by provinces on softwood lumber production.

b. Any such modifications in the export charge will be made by the Government of Canada. Calculation of the value of any replacement measures in relation to the export charge will be subject to further consultations and agreement between the two Governments.

c. The Government of Canada and the Government of the United States of America agree that the fiscal year 1985/86 for each province will be the reference year for establishing

the baselines from which increased provincial charges will be calculated.

6. ADDITIONAL UNDERTAKING

The Government of Canada will take no action, and will take all reasonable steps to ensure that no other governmental body in Canada takes any action, directly or indirectly, which has the effect of offsetting or reducing the export charge or replacement measures, except as provided in this Understanding.

7. EXCHANGE OF INFORMATION AND MONITORING

a. The Government of Canada and the Government of the United States of America will exchange information necessary for the implementation and monitoring of this Understanding. The Government of Canada will provide the Government of the United States of America with data concerning the level of Provincial and Federal softwood and total stumpage harvest, the total revenue collected from the sale of Provincial and Federal softwood and total timber, total export charge collected, total shipments of certain softwood lumber products to the United States of America, total lumber production by province and total softwood lumber production by province, for each fiscal year within three months of the close of the fiscal year or as soon thereafter as is practicable, having regard to the importance of these data for monitoring the Understanding.

b. The Government of the United States of America may require presentation of two copies of the Export Notice as a condition of entry into the United States of America of certain softwood lumber products. It is not the intention of the two Governments that entry will be denied in the event of minor deficiencies in the Export Notice.

c. Not later than sixty (60) days after the end of each quarter, the Government of Canada will provide the Government of the United States of America with a report on a province-by-province basis containing, at a minimum, the following: the quantity of softwood lumber products exported, the value on which the tax was paid, and the total tax collected for the quarter. If a monthly statement is requested, it will be provided not later than sixty (60) days after the end of that month.

d. If the Government of the United States of America presents the Government of Canada with information showing its concern with an identified problem of evasion or underpayment of the export charge or replacement

measures, the Government of Canada will provide to the Government of the United States of America information relevant to such concerns. The Government of the United States of America will hold such information in the strictest confidence and will make it available only to those government employees directly involved in the review of the identified problem.

8. CONCLUSIONS

a. The Government of Canada and the government of the United States of America will consult semiannually and otherwise at the request of either Government regarding any matter concerning this Understanding.

b. Six months from the effective date of this Understanding, the two governments will consult regarding the information exchanged under this Understanding.

c. If exports from Canada to the United States of any of the products listed in Appendix D show a rapid and substantial increase, the two governments will consult to determine whether any remedial action is required.

d. If exports from Canada to the United States of any of the products listed in Appendix A show a rapid and substantial decrease, the two governments will consult to determine whether any remedial action is required.

9. TERMINATION OF UNDERSTANDING

Either Government may terminate this Understanding at any time upon thirty (30) days written notice.

10. EFFECTIVE DATE

This Understanding is effective on the date of exchange of Notes confirming its acceptance by both Governments.

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The Softwood Lumber Dispute and Canada-U.S. Trade in Natural Resources

by
Michael B. Percy
and
Christian Yoder

In May 1986 the U.S. Coalition for Fair Lumber Imports filed a petition with the International Trade Commission in Washington, D.C., requesting a 27 per cent duty on Canadian softwood lumber imports. This reopened a dispute that Canada thought had been settled in Canada's favour in 1983. This time, however, the dispute was to have a radically different outcome: on December 30, 1986, following an unfavourable preliminary determination by the U.S. International Trade Administration, Canada agreed to impose a 15 per cent federal export tax.

Focused on British Columbia – the main source of Canada's softwood lumber exports – this interdisciplinary study reveals why the U.S. industry succeeded in gaining tariff protection where it had failed before. The authors examine the complex economic and legal arguments that underpinned the trade action. And they conclude that the result was not so much determined by the economic merits of the U.S. industry's case as by the politically charged context in which the issue arose and which in turn affected the U.S. quasi-judicial process. The "political economy," marked by a mood of protectionism in the Congress related to the fact that the United States is increasingly a high-cost producer of resource products, is what prevailed in the end.

More than a post mortem, this book draws lessons from the Softwood Lumber dispute with reference both to general Canada-U.S. trade in natural resources and to the bilateral negotiations under way on comprehensive free trade.

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